Chapter 2

Courts and Alternative Dispute Resolution

Case 2.1

N.D.Cal.,2011.
Gucci America v. Wang Huoqing
Slip Copy, 2011 WL 30972 (N.D.Cal.)
United States District Court,
N.D. California.
GUCCI AMERICA, Plaintiff,
v.
WANG HUOQING, Defendant.
No. C 09-05969 CRB.
Jan. 5, 2011.
ORDER ADOPTING REPORT AND RECOMMENDATION, GRANTING DEFAULT JUDGMENT AGAINST DEFENDANT, AND ENTERING PERMANENT INJUNCTION
CHARLES R. BREYER, District Judge.

The Court has reviewed Magistrate Judge Spero's Report and Recommendation. The Court finds the Report correct, well-reasoned, and thorough, and ADOPTS it in every respect. Accordingly, the Court GRANTS default judgment against Defendant Wang Huoqing on Plaintiffs' trademark infringement and false designation of origin claims. The Court awards statutory damages to each Plaintiff in the following amounts: for Gucci America, Inc. $440,000; for Bottega Veneta International S.A.R.L. $4,000; and for Balenciaga S.A. $8,000. The Court awards prejudgment interest to each Plaintiff in the following amounts: for Gucci America, Inc. $12,768.92; for Bottega Veneta International S.A.R.L. $116.08; and for Balenciaga S.A. $232.16. Additionally, the Court awards $233.33 in costs to each Plaintiff on the basis of Defendant's trademark infringement.

Further, a permanent injunction is hereby ENTERED against the Defendant as follows:

Defendant and his respective officers, agents, servants, employees, and attorneys, and all persons acting in concert and participation with him are hereby permanently restrained and enjoined from:

(a) manufacturing or causing to be manufactured, importing, advertising, or promoting, distributing, selling or offering to sell counterfeit and infringing goods using the Plaintiffs' Marks;

(b) using the Plaintiffs' Marks in connection with the sale of any unauthorized goods;

(c) using any logo, and/or layout which may be calculated to falsely advertise the services or products of Defendant offered for sale or sold via the websites: b2do.com, bag2do.cn, bag2do.com, bagdo.com, bagdo.net, bagdo2.com, bagdo2.net, bagpo.com, bagxo.com, bagxp.com, do2bag.com, do2bag.net, ebagdo.com, ibagdo.com, ibagto.com, my4shop.com, my4shop.net, my5shop.com, my5shop.net, myamart.com, myamart.net, myashop.cn, myashop.com, myashop.net, myhshop.com, mynshop. com, myokshop.com, and myrshop.com and/or any other website or business, as being sponsored by, authorized by, endorsed by, or in any way associated with Plaintiffs;

(d) falsely representing himself as being connected with Plaintiffs, through sponsorship or association;

(e) engaging in any act which is likely to falsely cause members of the trade and/or of the purchasing public to believe any goods or services of Defendant offered for sale o[r] sold via the websites: b2do.com, bag2do.cn, bag2do.com, bagdo.com, bagdo.net, bagdo2.com, bagdo2.net, bagpo.com, bagxo.com, bagxp.com, do2bag.com, do2bag.net, ebagdo.com, ibagdo.com, ibagto.com, my4shop.com, my4shop.net, my5shop.com, my5shop.net, myamart.com, myamart.net, myashop.cn, myashop.com, myashop.net, myhshop.com, mynshop.com, myokshop.com, and myrshop.com and/or any other website or business are in any way endorsed by, approved by, and/or associated with Plaintiffs;

(f) using any reproduction, counterfeit, copy or colorable imitation of the Plaintiffs' Marks in connection with the publicity, promotion, sale or advertising of any goods sold by Defendant via the websites: b2do.com, bag2do.cn, bag2do.com, bagdo.com, bagdo.net, bagdo2.com, bagdo2.net, bagpo.com, bagxo.com, bagxp.com, do2bag.com, do2bag.net, ebagdo.com, ibagdo.com, ibagto.com, my4shop.com, my4shop .net, my5shop.com, my5shop.net, myamart.com, myamart.net, myashop.cn, myashop.com, myashop.net, myhshop.com, mynshop.com, myokshop.com, and myrshop.com and/or any other website or business, including, without limitation, footwear, belts, sunglasses, handbags, wallets, hats, necklaces, bracelets, scarves, ties, and/or umbrellas;

(g) affixing, applying, annexing or using in connection with the sale of any goods, a false description or representation, including words or other symbols tending to falsely describe or represent goods offered for sale or sold by Defendant via the websites: b2do.com, bag2do.cn, bag2do.com, bagdo.com, bagdo.net, bagdo2.com, bagdo2.net, bagpo.com, bagxo.com, bagxp.com, do bag.com, do2bag.net, ebagdo.com, ibagdo.com, ibagto.com, my4shop.com, my4shop.net, my5shop.com, my5shop.net, myamart.com, myamart.net, myashop.cn, myashop.com, myashop.net, myhshop.com, mynshop.com, myokshop.com, and myrshop.com and/or any other website or business, as being those of Plaintiffs or in any way endorsed by Plaintiffs;

(h) offering such goods in commerce;

(i) otherwise unfairly competing with Plaintiffs;

(j) secreting, destroying, altering, removing, or otherwise dealing with the unauthorized products or any books or records which contain any information relating to the importing, manufacturing, producing, distributing, circulation, selling, marketing, offering for sale, advertising, promoting, renting or displaying of all unauthorized products which infringe the Plaintiffs' Marks; and

(k) effecting assignments or transfers, forming new entities or associations or utilizing any other device for the purpose of circumventing or otherwise avoiding the prohibitions set forth above.

Finally, the Court orders as follows:

(l) In order to give practical effect to the Permanent Injunction, the websites: b2do.com, bag2do.cn, bag2do.com, bagdo.com, bagdo.net, bagdo2.com, bagdo2.net, bagpo.com, bagxo.com, bagxp.com, do2bag.com, do2bag.net, ebagdo.com, ibagdo.com, ibagto.com, my4shop.com, my4shop.net, my5shop.com, my5shop.net, myamart.com, myamart.net, myashop.cn, myashop.com, myashop.net, myhshop.com, mynshop.com, myokshop.com, and myrshop.com are hereby ordered to be immediately transferred by Defendant, his assignees and/or successors in interest or title, and the Registrars to Plaintiff Gucci's control. To the extent the current Registrars do not facilitate the transfer of the domain names to Plaintiffs' control within ten (10) days of receipt of this judgment, the United States based Registry shall, within thirty (30) days, transfer the Subject Domain Names to a United States based Registrar of Plaintiffs' choosing, and that Registrar shall transfer the Subject Domain Names to Plaintiff Gucci; and

(m) Upon Plaintiffs' request, the top level domain (TLD) Registries for the websites: b2do.com, bag2do.cn, bag2do.com, bagdo.com, bagdo.net, bagdo2.com, bagdo2.net, bagpo.com, bagxo.com, bagxp.com, do2bag.com, do2bag.net, ebagdo.com, ibagdo.com, ibagto.com, my4shop.com, my4shop.net, my5shop.com, my5shop.net, myamart.com, myamart.net, myashop.cn, myashop.com, myashop.net, myhshop.com, mynshop.com, myokshop.com and myrshop.com shall place the websites on Registry Hold status within thirty (30) days of receipt of this Order, thus removing them from the TLD zone files maintained by the Registries which link the websites to the IP addresses where the associated websites are hosted.

IT IS SO ORDERED.

Case 2.2

Miss.,2014.
Brothers v. Winstead
129 So.3d 906
Supreme Court of Mississippi.

Phillips BROTHERS, Kilby Brake Fisheries, LLC and Harry Simmons
v.
Ray WINSTEAD.

No. 2011–CA–01846–SCT.
Jan. 9, 2014.
WALLER, Chief Justice, for the Court:

1. Defendants Phillips Brothers, Kilby Brake Fisheries, LLC, and Harry Simmons seek review of a $1,724,923 judgment in favor of Ray Winstead for shareholder and employment claims. Finding multiple errors, we reverse and render in part; and remand in part.

Facts & Procedural History

2. In March 2000, Kilby Brake Fisheries, LLC, was formed as a catfish hatchery and farm. An operating agreement was signed by the three members—Harry Simmons, Phillips Brothers, LP, and Ray Winstead. The Kilby Brake operating agreement provided each member a one-third percent ownership stake in Kilby Brake. At the start of the LLC, bank loans were made and signed by all three members as guarantors. There were three loans: one in the amount of $300,300 (for the purchase of inventory), one in the amount of $201,040 (the purchase of equipment), and one in the amount of $300,900 (revolving line of credit to be used for operating expenses). Shortly after Kilby Brake was formed, Phillips and Simmons purchased an adjacent catfish farm ("the Wise Place") to be used to support the Kilby Brake operation. Winstead declined to be a part of the purchase of the Wise Place.

3. The members agreed that Winstead would be the hatchery operator and, for his work, he would receive $30,000 per year from Kilby Brake and use of a company truck, and Kilby Brake would pay for his and his family's housing on the farm, utilities, and health insurance. Winstead, as hatchery operator, was subject to the direction of Simmons, serving as the manager under the operating agreement. Simmons, under the Kilby Brake operating agreement, was authorized to carry out the business functions of the hatchery, including borrowing money and check-writing.

4. Kilby Brake's records indicated it was profitable for only two of the almost eight years while Winstead was the hatchery operator. Simmons fired Winstead in late 2007.

5. In September 2009, Winstead filed a complaint against Kilby Brake, Harry Simmons, Chat Phillips, Simmons Farm Raised Catfish, Inc., Five Mile Fisheries, Inc., and H.D. Simmons Corp. in the Circuit

Court of Yazoo County.[FN1] His complaint was amended to add Phillips Brothers, LP, as a defendant. Winstead alleged that Simmons and Phillips Brothers had failed to pay him his agreed-upon salary, asserting claims of fraud, breach of fiduciary duty, corporate freeze-out, conversion, slander, slander *per se,* and tortious interference with business relations. He also requested an accounting and dissolution of the LLC.

FN1. Harry Simmons and Phillips Brothers were members of a number of other entities involved in the catfish industry. The partners' other companies also were named as defendants in Winstead's complaint.

6. Along with their answers, Simmons, Phillips and Kilby Brake (Defendants) filed counterclaims against Winstead asserting theft, conversion, usurpation of corporate opportunities, tortious interference with business relations, conversion, theft by deception, breach of contractual and fiduciary duties, and unjust enrichment. They requested replevin and judicial dissolution. The counterclaims alleged that Winstead took Kilby Brake property for his personal use, provided property to others to use, and sold property, including fish products, food products, equipment, chemicals and fuel without authorization, while retaining all profits. The trial court granted Winstead's motion to dismiss the claims of tortious interference with Kilby Brake's business relations and claims that were barred by the three-year statute of limitations.

7. Trial commenced in April 2011 and, at the completion, a jury awarded Winstead compensatory damages in the amount of $1,160,000 and punitive damages against Simmons of an additional $100,000. The court also awarded Winstead attorneys' fees and costs in the amount of $464,923, bringing the total judgment against Harry Simmons and Phillips Brothers to $1,724,923. Further, the court awarded post-judgment interest at a rate of eight percent. Defendants appealed. The jury denied three of Defendants' four counterclaims—theft, unjust enrichment, and breach of fiduciary duty. Kilby Brake prevailed on its replevin counterclaim, and the jury ordered that Winstead return the company truck to Kilby Brake.

8. Defendants filed a motion for judgment notwithstanding the verdict (JNOV) or, in the alternative, a motion for new trial, which were denied. Although both parties asked in their pleadings for the LLC to be dissolved, they were unable to agree about the terms of dissolution. In the final judgment, the parties' claims for judicial dissolution were dismissed without prejudice. No issue is made of this dismissal on appeal. Because of the many issues in this case, we will discuss the facts relevant to each issue below.

DISCUSSION

9. The issues raised by the three defendants in this appeal fall into six categories: (1) Whether the admission of testimony regarding an oral agreement for cash contributions violated the parol evidence rule; (2) whether there was sufficient evidence to support Winstead's award for fraud; (3) whether there was sufficient evidence to support Winstead's award for corporate freeze-out; (4) whether there was sufficient evidence to support Winstead's award for breach of fiduciary duty; (5) whether Kilby Brake is entitled to a new trial; (6) whether Winstead met the requisite elements of slander *per se?*

I. Whether the admission of testimony regarding an oral argument for case contributions violated the parol evidence rule.

[1] 10. Winstead asserted that Simmons and Phillips Brothers had agreed to provide $600,000 in paid-in capital from cash contributions for the purchase of the startup equipment and fish inventory. Over Simmons and Phillips Brothers' objections, the trial court allowed Winstead to testify to this alleged oral agreement because the operating agreement was "silent as to the contributions." Winstead's expert also was permitted to testify, over objections, that he believed it was the intent of Simmons and Phillips to pay $600,000 in capital, out of cash.

[2][3] 11. "Questions concerning the construction of contracts are questions of law that are committed

to the court rather than questions of fact committed to the fact finder." *Facilities, Inc. v. Rogers–Usry Chevrolet, Inc.,* 908 So.2d 107 (Miss.2005) (quoting *Miss. State Highway Comm'n v. Patterson Enters. Ltd.,* 627 So.2d 261, 263 (Miss.1993)). An appellate court applies a *de novo* standard of review for questions of law. *Starcher v. Byrne,* 687 So.2d 737, 739 (Miss.1997).

12. The relevant portion of the Kilby Brake operating agreement at issue is set out as follows:

ARTICLE VI
CAPITAL CONTRIBUTIONS AND CAPITAL ACCOUNTS

Section 6.1 *Initial Capital Contributions.* As initial capital contributions to the Company, the Members shall contribute the Property more particularly described in Schedule "A".[FN2]

FN2. See Schedule "A," attached as an exhibit to this opinion.

Section 6.2 *Additional Contributions.* Except as set forth in Section 6.1 above, no Member shall be required to make any capital contributions.

[4][5][6][7][8][9][10] 13. "The primary purpose of all contract construction principles and methods is to determine and record the intent of the contracting parties." *Royer Homes of Miss., Inc. v. Chandeleur Homes, Inc.,* 857 So.2d 748, 752 (Miss.2003) (citing *Kight v. Sheppard Bldg. Supply, Inc.,* 537 So.2d 1355, 1358 (Miss.1989)). In contract construction cases, the court's focus is on the language of the contract. *Royer Homes,* 857 So.2d at 752 (citing *Turner v. Terry,* 799 So.2d 25, 32 (Miss.2001); *Osborne v. Bullins,* 549 So.2d 1337, 1339 (Miss.1989)). A court should look to the "four corners" of a contract to determine how to interpret it. *McKee v. McKee,* 568 So.2d 262, 266 (Miss.1990). It is well established that "parol extrinsic evidence is not admissible to add to, subtract from, vary or contradict written instruments, contractual in nature, and which are valid, complete, unambiguous and unaffected by accident, mistake or fraud." *Byrd v. Rees,* 251 Miss. 876, 171 So.2d 864, 867 (Miss.1965). "Our concern is not nearly so much with what the parties may have intended, but with what they said, since the words employed are by far the best resource for ascertaining the intent and assigning meaning with fairness and accuracy." *In re Estate of Fitzner,* 881 So.2d 164 (Miss.2003) (citing *Simmons v. Bank of Miss.,* 593 So.2d 40, 42–43 (Miss.1992)). If the language in the contract is clear and unambiguous, the intent of the contract must be effectuated. *Rotenberry v. Hooker,* 864 So.2d 266, 270 (Miss.2003); *see also Pfisterer v. Noble,* 320 So.2d 383, 384 (Miss.1975). "The mere fact that the parties disagree about the meaning of a provision of a contract does not make the contract ambiguous as a matter of law." *Burton v. Choctaw County,* 730 So.2d 1, 6 (Miss.1997) (quoting *Cherry v. Anthony, Gibbs, Sage,* 501 So.2d 416, 419 (Miss.1987)).

14. This Court has said that "silence alone does not necessarily create an ambiguity as a matter of law." *Facilities, Inc. v. Rogers–Usry Chevrolet, Inc.,* 908 So.2d 107, 115 (Miss.2005). In *Facilities, Inc.,* this Court found that, although the Court of Appeals held that a lease agreement between the parties was not ambiguous, the Court of Appeals improperly considered extrinsic or parol evidence in the analysis portion of its opinion. *Id.* at 110. We found that, although the lease agreement was *silent* as to whether the bonus rent would apply to new vehicle sales at the subject property, it was *not ambiguous* and, therefore, Rogers–Usry was not required to pay bonus rent for sales that did not occur on the leased property. *Id.* at 115–16 ("It is the *silence, not the language of the* [operating agreement], that has created this dispute. However, silence alone does not necessarily create an ambiguity as a matter of law") (emphasis in original). Further, we noted this concept is not novel and has been adopted in a number of jurisdictions. *Id.*

15. The Kilby Brake operating agreement is clear. It states "no member shall be required to make any capital contributions" except as provided in Schedule A.[FN3] Nothing is listed in Schedule A. Kilby Brake was financed by the three loans totaling more than $800,000, which Winstead signed for and subsequently renewed as a one-third partner. For more than eight years, Winstead never raised an issue

about the capital investment. Winstead's expert testified that it was not unusual to leave capital contributions blank for completion at closing. No amounts were ever filled in or added.

FN3. See Schedule "A," attached as an exhibit to this opinion.

16. Constraining our review to the "four corners" of the document, it is clear the language used in the Kilby Brake operating agreement is not ambiguous. Thus, it was error for the trial court to go outside the operating agreement to interpret the intent of the parties. Because the trial court never should have considered the offer to make cash contributions, the interest-expense-savings portion of Winstead's corporate freeze-out damage award also is without merit. We thus reverse the judgment of the trial court on its parol-evidence finding as well as the damages awarded and render judgment in favor of Simmons on this portion of Winstead's freeze-out damages. Having limited our review to the admissible evidence, we now address the merits of Defendants' claims.

II. Whether there was sufficient evidence to support Winstead's award for fraud.

17. Winstead's theory of recovery for fraud was based on two claims. The first is that Simmons and Phillips Brothers purchased the Wise Place in their names only, with funds from Kilby Brake. The second is that money was withheld fraudulently from his salary. Winstead was awarded a total of $140,000 for fraud: $90,000 for one-third of the value of the Wise Place and $50,000 for money withheld from his paychecks. Simmons and Phillips Brothers were both found liable and both moved for JNOV, arguing Winstead had failed to prove all of the elements of fraud by clear and convincing evidence or, in the alternative, that the overwhelming weight of the evidence required a new trial.

[11][12][13][14][15] 18. The standard of review for the denial of a motion for JNOV is *de novo. InTown Lessee Assocs., LLC v. Howard,* 67 So.3d 711, 718 (Miss.2011). We consider the facts in the light most favorable to the nonmoving party. *Natchez Elec. & Supply Co. v. Johnson,* 968 So.2d 358, 361 (Miss.2007). " 'If the facts so considered point so overwhelmingly in favor of the appellant that reasonable men could not have arrived at a contrary verdict, [we are] required to reverse and render.' " *Leaf River Forest Prods., Inc. v. Ferguson,* 662 So.2d 648, 659 (Miss.1995) (quoting *Munford, Inc. v. Fleming,* 597 So.2d 1282, 1284 (Miss.1992)). We will affirm the denial of JNOV if there is substantial evidence in support of the verdict. *Natchez Elec. & Supply Co.,* 968 So.2d at 362. "Substantial evidence is information of such quality and weight that reasonable and fair-minded jurors in the exercise of impartial judgment might have reached different conclusions." *Id.* (citations omitted).

[16][17] 19. In order to recover for fraud, a plaintiff must prove the following elements: "(1) a representation; (2) its falsity; (3) its materiality; (4) the speaker's knowledge of its falsity; (5) his intent that it should be acted on by the hearer and in the manner reasonably contemplated; (6) the hearer's ignorance of its falsity; (7) his reliance on its truth; (8) his right to rely thereon; and (9) his consequent and proximate injury." *Holland v. Peoples Bank & Trust Co.,* 3 So.3d 94, 100 (Miss.2008) (citations omitted). These elements must be proven by clear and convincing evidence. *Bank of Shaw v. Posey,* 573 So.2d 1355, 1363 (Miss.1990). Clear and convincing evidence is of such a high order that "this Court held that the 'overwhelming weight of the evidence' falls short of being 'clear and convincing.' " *In the Interest of C.B.,* 574 So.2d 1369, 1375 (Miss.1990) (quoting *Aponaug Mfg. Co. v. Collins,* 207 Miss. 460, 42 So.2d 431, 434 (1949)).

A. The Wise Place

[18] 20. The Wise Place is a catfish farm located adjacent to Kilby Brake. Winstead testified that Simmons informed him that "they had gotten the Wise Place" and that it was his understanding "that, basically, Kilby Brake bought the Wise Place." Simmons testified that he and Phillips Brothers purchased the Wise Place and the equipment thereon individually and allowed Kilby Brake to use it as part of the hatchery operation. He further testified that Winstead was unwilling to join in the purchase because he did not feel that a bank would lend him more money. The deed to the property was dated April 12, 2000, and

was recorded in the names of Harry Simmons and Phillips Brothers.

21. At trial, Simmons initially testified that the purchase price of the Wise Place was $190,000, however, he later explained that the total purchase price for the land and equipment was $230,000. Phillips also testified that the purchase price for the land at the Wise Place was $190,000, but that the equipment that came with the deal was an additional cost. Simmons and Phillips Brothers permitted Kilby Brake to use the Wise Place, rent free, and even gave the proceeds from the sale of the Wise Place equipment to Kilby Brake. Although Kilby Brake did not pay rent for use of the Wise Place, Kilby Brake spent $78,305.70 to make improvements to the pond walls and access roads to benefit Kilby Brake.

22. At the start of the company, Kilby Brake secured three loans from BankPlus, which were signed by all members, totaling $800,000. Simmons testified that they paid $400,000 for inventory and $200,000 for equipment, which left $200,000 in operating capital. A Kilby Brake bank statement from March 2000 was submitted into evidence showing that $610,000 was deposited into the account. Winstead's attorney thoroughly questioned Simmons about the purchase of the Wise Place and the March 2000 bank statement, claiming this is where the $190,000 came from to purchase the Wise Place. Simmons denied this, later testifying that he recalled purchasing the Wise Place with Phillips Brothers using cash.

23. The record contains no evidence that Kilby Brake funds were used to purchase the Wise Place. Winstead's forensic accountant, Robert Alexander, testified that *no* Kilby Brake funds were used to purchase the property, and neither Simmons nor Phillips *ever* took any money from the Kilby Brake account, whether salary, dividends, or other distributions. The deed to the Wise Place was in the name of Simmons and Phillips Brothers and was on record at the Humphreys County Courthouse. Interestingly, the jury form stated Simmons and Phillips Brothers were guilty of a material misrepresentation and all nine elements of fraud but then stated the jury found Simmons and Phillips Brothers not guilty of "misappropriat[ing] and convert[ing] Kilby Brake Fisheries' funds or property...."

24. This Court finds that insufficient evidence, much less clear and convincing evidence, was presented to prove the funds to purchase the Wise Place came from Kilby Brake. Further, Winstead's mere assertion that he thought Kilby Brake owned the Wise Place is not enough to carry his burden that he was defrauded by Simmons and Phillips Brothers. We find that the trial court erred by failing to grant Defendants' motion for JNOV for the claim of fraud surrounding the purchase of the Wise Place. Thus, we reverse and render judgment on this issue in favor of Simmons and Phillips Brothers.

B. Withheld Pay

[19] 25. The jury ruled Winstead was defrauded by Phillips Brothers and Simmons with regard to withholdings from his paycheck over the course of his employment at Kilby Brake. Whether Winstead was owed money based on the amounts withheld from his paycheck was heavily contested by both sides. Winstead claims improper deductions were taken from his paychecks and he was never paid the amount he was promised. Simmons claims Winstead actually owed Kilby Brake for personal charges and cash advances. Both sides produced documents which were admitted into evidence showing records of payments and deductions. Based on Winstead's stated $30,000 annual salary, Alexander calculated that Winstead was owed $50,000 in withheld pay over eight years. The jury found Phillips Brothers and Simmons liable for $25,000 each.

26. In *Natchez Electric Supply Inc.,* the plaintiff was seeking to recover on an open account. Despite some uncontroverted charges by the defendant, the jury returned a defense verdict with no recovery for the plaintiff. Because the record contained undisputed evidence of one party's obligation to pay another, this Court held "no reasonable and fair-minded juror in the exercise of fair and impartial judgement" could find the obligating party owed absolutely nothing. *Natchez Elec. & Supply Co., Inc.,* 968 So.2d at 363. The case at bar bears striking similarities.

27. In the record we find Winstead admitting to making personal charges on his Kilby Brake account for some items that were indisputably personal, such as multiple deer-rifle scopes, dog food, and hunting accessories. When asked if the purchase of a "Gobbler's Lounge," used for turkey hunting, was for Kilby Brake, Winstead responded, "[n]o sir. That would be a personal item for me." It was further undisputed that Winstead charged Kilby Brake for gasoline used at his father's hunting camp in Durant. Winstead's damages for lost pay were based on testimony that money was taken out of all his paychecks; however, payroll records indicate that Winstead was actually paid in excess of his $30,000 annual salary for four of his eight years with Kilby Brake. What is more, Winstead admitted he had received cash advances on his paycheck and that money subsequently would be taken out to repay the advances. Because fault was apportioned between Phillips Brothers and Simmons, we address both separately.

28. As to Phillips Brothers, we can find no proof of any involvement in the decision-making process regarding the execution of Winstead's checks. Contractually, Simmons was the manager and supervised Winstead. The only testimony in the record regarding Winstead's salary was between Simmons and Winstead. Further, all actions on Winstead's pay checks, including any deductions, were made by Simmons and his bookkeepers, not by Phillips Brothers. Winstead even testified that he and Phillips had very little contact, and when they did, they "didn't discuss the farm a whole lot." Nothing in the record indicates Phillips Brothers ever made a representation to Winstead regarding his pay at all. Thus, there is no evidence at all that Phillips Brothers fraudulently withheld pay from Winstead's salary. We therefore reverse and render judgment in favor of Phillips Brothers.

29. With regard to Simmons, Winstead admitted at trial that he knew deductions were taken from his paycheck for cash advances and for personal charges he made on his Kilby Brake account. Although Winstead disagreed that some of the charges were personal in nature, there was no dispute that he was aware Simmons was making deductions. We find no clear and convincing evidence in the record that any pay shortage which may have occurred was caused by a fraudulent representation made by Simmons upon which Winstead relied. Thus, we reverse the judgment against Simmons for fraud with regard to withheld pay.

30. However, Kilby Brake may be liable to Winstead for any improper deductions from Winstead's pay that may have occurred, or Winstead may be liable to Kilby Brake if it is shown he still owes money to Kilby Brake for charges made on his account. We find Winstead's own testimony, coupled with other evidence in the record, provides overwhelming evidence, based upon which no reasonable and fair-minded juror in the exercise of fair and impartial judgment could award Winstead the full amount that he alleged was taken from each of his paychecks.

31. In addition, for reasons discussed below, we reverse and remand this issue to the trial court for a new trial to determine any amounts Kilby Brake may owe Winstead or vice versa.

III. Whether Winstead proved the requisite elements of corporate freeze-out.

32. As early as 1913, this Court used the term 'frozen out' when it held that a chancery court could appoint a receiver for a corporation to wind up the business at the insistence of minority stockholders "when it shall appear that by gross mismanagement ... the rights of the stockholders ... are being put in jeopardy." *Brent v. B.E. Brister Sawmill Co.,* 103 Miss. 876, 60 So. 1018, 1022 (1913). Since that time, Mississippi courts began to recognize freeze-out [FN4] as a distinctly individual and direct cause of action, separate from a derivative action. *See, e.g., Bluewater Logistics, LLC v. Williford,* 55 So.3d 148 (Miss.2011); *Missala Marine Serv., Inc. v. Odom,* 861 So.2d 290 (Miss.2003); *Fought v. Morris,* 543 So.2d 167 (Miss.1989); *Cook v. Wallot,* ––– So.3d –––– (Miss.Ct.App.2013); *Knights' Piping, Inc. v. Knight,* 123 So.3d 451 (Miss.Ct.App.2012), *cert. denied,* 2011–CT–00409–SCT, 123 So.3d 450 (Oct. 3, 2013). This Court recognized in *Fought v. Morris* that "the distinctive characteristics and needs" of closely held corporations made them different from traditional corporations. *Fought v. Morris,* 543 So.2d 167, 169 (Miss.1989).

FN4. Other jurisdictions use the term "squeeze out."

[20] 33. A closely held corporation is a "business entity with few shareholders, the shares of which are not publicly traded." *Fought v. Morris,* 543 So.2d 167, 169 (Miss.1989). This Court has held that limited-liability corporations with few members resemble closely held corporations. *See Bluewater Logistics, LLC v. Williford,* 55 So.3d 148, 161 (Miss.2011). Minority shareholders in closely held corporations are particularly vulnerable, because they usually lack the control the majority has and there is seldom a fair market available for selling their shares. *Fought,* 543 So.2d at 170 (citing *Orchard v. Covelli,* 590 F.Supp. 1548, 1557 (W.D.Pa.1984); *aff'd* 802 F.2d 448 (3rd Cir.1986)). Thus, if a dispute arises between the minority member and the majority, it is usually the case that a "minority shareholder can neither profitably leave, nor safely stay with, the corporation." *Fought,* 543 So.2d at 171.

34. Because of their size, membership in closely held corporations resembles that of a partnership rather than a traditional corporation with directors and stockholders. In its most classic form, a freeze-out of the minority shareholders by the majority occurs when the majority purposefully denies the minority member from sharing proportionally in corporate earnings or gains. This could be accomplished by a number of techniques. For example, the majority could refuse to declare dividends, pay themselves exorbitant salaries, or sell corporate assets to themselves at inadequate prices. *See* F.H. O'Neal and R. Thompson, *O'Neal's Oppression of Minority Shareholders* § 3.02 (2d ed.1985). The freeze-out cause of action, therefore, addresses the central problem: the majority, through its right of control, intentionally reduces or eliminates the minority shareholder's right to corporate earnings or gains coupled with virtual inability of the minority member to withdraw or sell.

35. Although the jury instructions used at trial in the case before us state there are "elements" to the corporate freeze-out cause of action, no specific elements were set out. This Court previously has said that "[c]orporate freeze-out is an intentional tort that is committed with *willful* and *wanton* disregard for the right of the shareholder who is frozen out." *Missala Marine Serv., Inc. v. Odom,* 861 So.2d 290, 295 (Miss.2003) (emphasis added); *Bluewater,* 55 So.3d at 163 (upholding chancellor's finding that willful and grossly negligent breach of the operating agreement constituted freeze-out). Recognizing the problems inherent in close corporations, the *Fought* Court held that majority shareholder actions in these close corporations must "be 'intrinsically fair' to the minority interest." 543 So.2d at 171 (*overruling Ross v. Biggs,* 206 Miss. 542, 40 So.2d 293 (1949)). The Court went on to define expressly the relationship between those in control and minority members, stating "[d]irectors and officers of a corporation stand in a fiduciary relationship to the corporation and its stockholders. These duties include exercising the utmost good faith and loyalty in discharge of the corporate office." *Id.* (citations omitted). We noted recently that the *Fought* rationale "applies with equal force" to limited-liability companies. *Bluewater Logistics, LLC v. Williford,* 55 So.3d 148, 161 (Miss.2011).

[21][22] 36. Using traditional elements for an intentional-tort claim and reviewing the above-discussed cases, we find that, in order to prove a claim of corporate freeze-out, the plaintiff must establish: (1) the existence of a legally defined duty owed to or right of a minority shareholder arising out of his or her ownership interest in a corporation; (2) the intentional or willful breach of that duty by the majority or controlling shareholder(s); (3) that the breach proximately caused plaintiff's direct injury; and (4) the fact and extent of injury. *See generally* Prosser & Keeton, *On the Law of Torts* § 30 (5th ed.1984). When we evaluate the duties and the alleged breach of these duties, we will look to the parties' agreements and applicable state law. In the case of Kilby Brake, LLC, that would be applicable caselaw, the Kilby Brake operating agreement, and the March 2000 version of the Mississippi Limited Liability Company Act. *See* Miss. Laws Ch. 402, §§ 1–87, *repealed by* Revised Mississippi Limited Liability Company Act, 2010 Miss. Laws Ch. 532, § 1, eff. Jan. 1, 2011. *See also* Miss.Code Ann. §§ 79–29–101 to 79–29–1317 (Rev.2013).

37. In his argument for freeze-out, Winstead alleged Simmons and Phillips Brothers took actions to

exclude Winstead from his ownership interest in Kilby Brake without justification and in willful disregard of Winstead's rights. Winstead's amended complaint states this conduct did not "allow him to in any way participate as a true managing shareholder during his eight years with Kilby Brake." In support of this claim, Winstead argued Phillips and Simmons did not make alleged cash contributions to start the LLC; they misappropriated funds from Kilby Brake; Simmons made detrimental loans for the company without his consent; and Simmons did not allow him to inspect the company books. After he was fired as hatchery operator and moved off the farm, Winstead claimed Simmons and Phillips Brothers mismanaged Kilby Brake to his detriment. The jury found only Simmons guilty of freezing out Winstead.

38. As noted above, we found the alleged promise of cash contributions inadmissable and that Winstead had failed to prove Simmons or Phillips Brothers committed fraud by misappropriating funds from Kilby Brake; thus, these arguments as a basis for his freeze-out claim are without merit. The only remaining claims by Winstead are that Simmons improperly fired him, made detrimental loans to the LLC, refused to share financial records with Winstead, and that Simmons and Phillips Brothers mismanaged Kilby Brake after he was fired in 2008. Thus, we look to see if these claims give rise to a cause of action for corporate freeze-out.

1. Participation as a Managing Shareholder

[23] 39. The Kilby Brake operating agreement named Harry Simmons as manager. It stated that Simmons, as manager, had "full and complete authority, power and discretion to manage and control the business, affairs, and properties of [Kilby Brake]...." Further, the operating agreement gave Simmons alone the power to acquire property from any person, to borrow money from banks or other members of Kilby Brake on the terms Simmons deemed appropriate, control the business affairs of the company and to make "all decisions regarding those matters." Winstead admitted at trial he signed the operating agreement and understood all of the terms. Although Winstead asserted he "managed" the day-to-day operations, he admitted he was not named as a manager of Kilby Brake anywhere in the operating agreement and that his title was hatchery operator. Simmons never needed Winstead's permission to borrow money on behalf of Kilby Brake. Further, it is evident from the record that, had Simmons not borrowed the money from his other entities, Kilby Brake would have ceased business operations. When asked whether Simmons had the authority as manager to borrow money to be sure that payroll was made, Winstead answered affirmatively.

40. We find nothing in the record that would lead to the conclusion that Winstead could participate in Kilby Brake as a managing shareholder. Further, Simmons, as the only manager of Kilby Brake, did not use his control of Kilby Brake to violate any terms of the operating agreement, thereby breaching the duty he owed to Winstead. Thus, Winstead's argument that he was frozen out of the LLC because he was denied participation as "a true managing shareholder" in the company is without merit.

2. Winstead's Termination as Hatchery Operator

[24] 41. Although many commentators point to being fired by management as possible evidence a minority member in a closely held corporation has been frozen out, the Fifth Circuit has held that in employment-at-will states like Mississippi, nonmanaging members of a closely held corporation do not have "fiduciary-rooted entitlements to their jobs." *Hollis v. Hill,* 232 F.3d 460, 470 (5th Cir.2000). *See also Knights' Piping, Inc. v. Knight,* 123 So.3d at 459 (Miss.Ct.App.2012) ("a majority shareholder does not breach his fiduciary duty when he terminates a minority shareholder if he has 'acted pursuant to a legitimate business purpose.' "). There is nothing in the Kilby Brake operating agreement that could be construed as guaranteeing Winstead employment with Kilby Brake. Further, there was certainly enough evidence in the record to suggest Simmons was acting pursuant to a legitimate business purpose in firing Winstead.

42. Simmons had designated authority as manager to terminate Winstead. Though not required, Simmons had several arguable causes to fire Winstead. Winstead made several personal charges on his

Kilby Brake account, even after he was told not to. Winstead used Kilby Brake employees, while they were being paid by Kilby Brake, to make improvements to his deer camp and to work in his father's ham store during the holidays. Kilby Brake equipment also was used to make improvements to Winstead's deer camp. The survival ratio of fish was around forty to fifty percent under Winstead and increased to seventy-five percent after he left the hatchery. Most importantly, the business was profitable for only two of the eight years Winstead ran the day-to-day operations at the hatchery. Thus, we find Simmons presented sufficient evidence to show he acted pursuant to a legitimate business purpose, and Winstead's firing did not, by itself, constitute a freeze-out of his interest.

3. Inspection of Kilby Brake Finances

[25] 43. The Kilby Brake operating agreement states that every member, at their own expense, "shall have the right to inspect, copy, and audit [Kilby Brake's] books and records at any time during normal business hours without notice to any other member or the manager." It also states each member "shall be furnished [with] ... a copy of the balance sheet of [Kilby Brake]" for each accounting period. The records for Kilby Brake all were held at Kilby Brake's principal place of business, which was Simmons's office in Yazoo City.

44. The record shows Simmons proposed that either he or Winstead leave the company in mid-to-late 2007. Winstead alleged that he was interested in purchasing Kilby Brake, but that Simmons failed to provide him with appropriate company financial information that he needed to obtain a loan from a bank. Simmons testified he could not recall the last time that he had sent a balance sheet to Winstead and he doubted that he had sent one since Winstead moved off the farm in January 2008. He further admitted that Winstead remained a member of the LLC, was entitled to the records, and that he continued to send them to Phillips Brothers. However, Simmons delivered 3,500 pages of financial documents relating to Kilby Brake to Winstead's accountant in Canton in June 2008.

45. Winstead never presented any evidence to show he was denied access to Kilby Brake's offices and records or that he even attempted to "inspect, copy, and audit" the records at his own expense, which, under the operating agreement, he had a right to do without notice to Simmons. However, as manager and keeper of the records, Simmons also had a duty under the operating agreement to furnish his other partners with balance sheets for each accounting period, which he admittedly did not do for Winstead once he was fired.

46. Although Simmons arguably breached his duty to Winstead by not providing the balance sheets to him, Winstead did not present any evidence on how these acts damaged him. The purpose of trying to obtain the financial documents from Simmons was to try and get financing to purchase Kilby Brake. Winstead had a right under the operating agreement to inspect and copy Kilby Brake's books without Simmons's permission. And Simmons eventually delivered the voluminous documents to Winstead's accountant prior to filing suit; thus, we find this claim to be without merit.

4. Mismanagement in 2008

[26] 47. Winstead's claim for mismanagement was submitted to the jury in the same instruction as his freeze-out claim. Winstead received damages on his mismanagement claim in both his award for freeze-out and breach of fiduciary duty. The jury instruction stated that, to prove a claim for mismanagement, "Winstead must show by a preponderance of the evidence that during his corporate freeze-out, Harry Simmons and Phillips Brothers made decisions, purchases, or acquisitions without his consent and that *these actions devalued the business, and in turn, Plaintiff's ownership interest.*" (Emphasis added.) Winstead's argument alleges Simmons's mismanagement of Kilby Brake caused a lack of corporate gains and devalued his interest. Thus, it clear from his amended complaint and the jury instruction at trial that these allegations are better viewed as a derivative claim on behalf of Kilby Brake and not a direct cause of action for corporate freeze-out. *See Mathis v. ERA Franchise Systems, Inc.,* 25 So.3d 298, 303 (Miss.2009) ("[I]n determining whether the action belongs to the corporation or the individual, the focus of

the inquiry is whether the corporation or the individual suffered injury.”).

48. In the case *sub judice,* Winstead presented a number of claims that were derivative because he sought relief on behalf of Kilby Brake, and his injury was based on his ownership in the company. This Court requested supplemental briefing on the issue of whether it was error for the circuit court to allow the claims to proceed without making a determination of whether the “ *Murray* exceptions [FN5]” applied, which would permit Winstead to bring the derivative claims in a direct action. *See Derouen v. Murray,* 604 So.2d 1086, 1091 (Miss.1992).

> FN5. The Murray exceptions allow for derivative claims to be tried as direct actions if the trial judge finds that doing so will not: “(i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons.” *Derouen v. Murray,* 604 So.2d 1086, 1091 n. 2 (Miss.1992).

[27] 49. Although the trial court did not apply the *Murray* exceptions, Defendants never challenged whether Winstead should be permitted to bring the derivative claims in a direct action; therefore, we find the derivative claims were tried by implied consent, and the pre-trial procedural requisites that apply in derivative actions were waived. *See id.* We also find that the trial court was not required to consider, *sua sponte,* whether Winstead was entitled to bring the derivative claims as a direct action; therefore, the trial court did not err in failing to address the issue.

[28][29] 50. Alabama, like Mississippi, has held that managers in a closely held corporation owe a duty to act fairly to minority interests. *See Burt v. Burt Boiler Works, Inc.,* 360 So.2d 327, 331 (Ala.1978). We find persuasive the statement of the Alabama Supreme Court that the freeze-out cause of action “is not a panacea for any and all conduct undertaken ... that could be deemed ‘unfair’ to the minority.” *Stallworth v. AmSouth Bank of Alabama,* 709 So.2d 458, 468 (Ala.1997). “[A] minority shareholder cannot parlay a wrong committed primarily against the corporation, which gives rise to a derivative claim only, into a personal recovery of damages under a squeeze out theory by simply stating the injury to the corporation is also ‘unfair’ to him as well.” *Id.* at 467. Even though we find this language to be persuasive, Winstead claimed the mismanagement of Kilby Brake factored into his freeze-out. Thus, we review this claim in light of the elements we have cited above for corporate freeze-out, which necessarily include proving the conduct complained of was willful and wanton and that it proximately caused individual damages.

51. Winstead argued at trial and in his brief that, after he was fired, “Simmons undertook activities which negatively affected Kilby's financial sustainability and further devalued Winstead's interest.” Winstead presented evidence that, in the year following his term as hatchery operator, Kilby Brake's sales decreased by seventy-six percent, from $756,451.64 in 2007 to $181,146.44 in 2008. Winstead's expert, Alexander, testified that, while Winstead was operator, Kilby Brake's sales consistently were close to $775,000 per year. Alexander further testified that, although the economy was bad, the economy was not the cause of the nearly eighty-percent decline in sales. In fact, Kilby Brake's sales were back up in 2009.

52. None of the parties disputes that sales were low in 2008 and, of course, each side blames the other. Simmons testified that sales were low because there were no fish in 2008 and attempted to show that Winstead was responsible for the missing fish by either taking them or mismanaging the farm. Members of Kilby Brake's staff testified that, when the ponds were seined in 2008, there was a remarkably low number of fish. However, evidence showed that the seining and feed expenses in 2008 were higher than they were in 2007. Simmons testified this was because he had to restock the ponds to replace the fish that were missing. Winstead argued that the increase in food and seining costs indicated there were fish at Kilby Brake that were not reported. In sum, a sharp dispute exists in the record as to what happened to the fish.

53. A number of witnesses testified that if Winstead had moved the millions of missing fish, someone would have known. In fact, testimony was presented that it would be nearly impossible to move the fish in the night and that moving the fish would require a crew of six men, two tractors, a seine and reel, and a boat to move a million fish. However, there was also testimony that large amounts of "swim-up fry" could be moved in a standard ice chest. Alexander stated that he could not testify that the defendants caused the drop in sales; however, he testified that the sales should have occurred if the parties had carried on normal business in Winstead's absence.

54. To carry his claim for corporate freeze-out, Winstead was required to demonstrate that Simmons intentionally and willfully used his control of Kilby Brake in 2008 in a way that harmed Winstead individually. We find Winstead failed to prove that Simmons "willfully and wantonly" mismanaged Kilby Brake in a manner that harmed Winstead alone.

5. Conclusion on Corporate Freeze-out

55. Taken as a whole, Winstead failed to prove that he was frozen out of Kilby Brake by Simmons. The record does not indicate that Simmons used his position in control of Kilby Brake to breach a duty he owed to Winstead by denying him his proportional share of any corporate benefits. The reality is the record does not reflect any corporate gains whatsoever. Winstead's expert testified that neither Simmons nor Phillips Brothers ever received any payment from Kilby Brake in the form of salary, dividends, or any other distribution. None of the actions undertaken by Simmons, which Winstead might have felt to be unfair to him, circumvented the powers delegated to Simmons under the Kilby Brake operating agreement. When viewing Winstead's complaints for freeze-out in light of the agreements of the parties and applicable law, we find Simmons did nothing to willfully breach the duty he owed to Winstead. Therefore, for the reasons stated above, we reverse and render the judgment of corporate freeze-out against Simmons.

IV. Whether Simmons and Phillips Brothers breached a fiduciary duty they owed Winstead.

[30] 56. The jury found both Simmons and Phillips Brothers breached a fiduciary duty they owed to Winstead and awarded him $395,000, being two thirds of Alexander's valuation of the missing fish sales in 2008 due to mismanagement. Simmons and Phillips Brothers argued first that they did not breach a duty owed to Winstead or, in the alternative, Winstead's damages were speculative and amounted to a double recovery. Winstead counters that a plaintiff who proves breach of a fiduciary duty is entitled to the damages incurred as a result of the breach.

57. In his amended complaint, Winstead argued Simmons and Phillips Brothers "negligently, carelessly, and intentionally failed to perform their duties as ... managing officers of Kilby Brake so that the assets of Kilby Brake ... were mismanaged, wasted, diverted to and converted by the defendants...." A breach of fiduciary duty owed to Kilby Brake should be separated from Winstead's corporate freeze-out claim, which is an individual claim for Simmons's intentional breach of the duty owed directly to Winstead that caused him personal damages, separate and apart from any damages to Kilby Brake. *See Fought,* 543 So.2d at 171 (" 'any attempt [by the majority] to squeeze out a minority shareholder must be viewed as a breach of his fiduciary duty ....' ") (quoting *Orchard v. Covelli,* 590 F.Supp. 1548, 1557 (W.D.Pa.1984), *aff'd* 802 F.2d 448 (3d Cir.1986)). By contrast, a claim that Simmons breached his fiduciary duty through mismanagement or dissipation of corporate assets belongs to the corporation because the wrong necessarily damages the corporation and damages Winstead only derivatively. [FN6] *See Mathis,* 25 So.3d at 304.

FN6. We make this distinction to emphasize that the corporate freeze-out cause of action is distinct from a general breach of fiduciary duty because of the injury involved. Indeed, if a plaintiff proves he or she has been intentionally frozen out, that cause of action would also be the support for an award of personal damages for a breach of fiduciary duty. However, if the wrong directly damages the corporation and its assets from waste, conversion, and mismanagement, the claim is the corporation's.

58. This Court held in *Fought* that directors and officers in a closely held corporation stood in a fiduciary relationship with the corporation and its members. *Fought,* 543 So.2d at 171; *see also Bluewater,* 55 So.3d at 161 (holding the *Fought* rationale "applies with equal force" to limited liability companies). Before we look to any common-law standards of care, we look to the agreement of the parties. The Kilby Brake operating agreement and *Fought* lead us to conclude that Simmons, as manager, owed a fiduciary duty to the other members of Kilby Brake. However, the operating agreement also indemnified Simmons from any actions he took on behalf of Kilby Brake as long as he "conducted himself in good faith" and reasonably believed "his conduct was in [Kilby Brake's] best interest." Thus, for Winstead to succeed on his claim that Simmons's mismanagement of Kilby Brake in 2008 breached the fiduciary duty Simmons owed Kilby Brake, he must first establish that Simmons was at the very least in breach of the Kilby Brake operating agreement. Because Simmons and Phillips Brothers both were found to have breached the duties they owed to Winstead, we discuss them separately.

59. It is clear from the record that Winstead ran the day-to-day operations at the farm. After he was fired, Simmons took over this responsibility and hired a new hatchery operator, Dan Bradshaw. Importantly, Phillips Brothers was never involved in decision-making in the day-to-day operations of Kilby Brake. There is no proof that any employee from Phillips Brothers visited Kilby Brake at the time the fish went missing or that any fish were moved to property in which Phillips Brothers had an interest. If anything, the damages resulting from the mismanagement of Kilby Brake in 2008 were detrimental to the Phillips Brothers' one-third interest in the company as well. Although as co-members of Kilby Brake, each party owed a fiduciary duty to the other, Winstead presents no evidence that this duty was breached by Phillips Brothers with regard to the mismanaged assets in 2008. Thus, we reverse the jury's judgment on this claim and render a decision in favor of Phillips Brothers.

60. Simmons, as manager of Kilby Brake, owed a duty to Winstead even after he was fired. As noted above, both parties presented plenty of evidence and conjecture as to what caused the missing fish sales in 2008. However, as will be discussed below, we find prejudicial error in the trial court's decisions to prevent Kilby Brake from discovering and cross-examining Winstead on certain financial items that will necessitate a new trial on whether Simmons breached a fiduciary duty he owed to Winstead. Because we also find error in Winstead's damages for breach of fiduciary duty, we discuss those first.

A. Damages for Breach of Fiduciary Duty

[31] 61. Winstead received one third of the value of his interest in Kilby Brake as calculated by his expert in his damages for corporate freeze-out.[FN7] This calculation included one third of the value of the missing fish sales from 2008. Winstead received the other two-thirds of the value of the missing fish sales in his damages for breach of fiduciary duty. Due to the numerous errors in Winstead's expert's valuation of what Kilby Brake was worth and the amount of the missing fish sales and because Kilby Brake also was improperly limited in its discovery and cross-examination of Winstead as discussed in Issue V *supra,* we must reverse and remand for a new trial with regard to any breach of fiduciary duty.

FN7. Alexander calculated the value of Kilby Brake as follows:

KILBY BRAKE VALUE AT 9/30/09			
Initial equity investment	600,000		
Cumulative interest exp savings to 9/09	459,303		
Missing sales from 2008	591,191	<>	See separate damage calculation
"But for" Value at 9/09	**$ 1,515,534**		
Value for 1/3 ownership interest	**$ 505,178**		**Ray Winstead's ownership interest**

Adjustment for Inventory value increase			
Unadjusted inventory at 9/09	1,375,589		
Price increase - 25%	343,897		
Inventory valued at current prices	**1,719,486**	<>	Revised inventory value

KILBY BRAKE VALUE WITH INVENTORY AT TODAY'S PRICES			
Kilby Brake value from above	1,515,534		
Price adjustment	343,897		
"But for" value at today's prices	**1,859,432**	<>	Revised Kilby Brake value
Value for 1/3 ownership interest	**$ 619,811**	<>	**Ray Winstead's ownership interest**

62. To begin, Alexander erroneously used the alleged promise of cash contributions at the formation of the LLC and cumulative interest savings to help determine a faulty starting value of Kilby Brake addressed in Issue I *supra.* In addition, Alexander calculated the price of the mismanaged assets, being the missing fish sales in 2008, to be $591,191 and added this number into his total valuation of Kilby Brake. Because we reverse and render the findings of the trial court on the alleged cash contributions and cumulative interest expense savings, the only damages left to assess are the damages for the missing fish sales.

63. Winstead was required to provide substantial proof of damages that he suffered so the jury could have a reasonable basis to assess his loss. *Missala Marine,* 861 So.2d at 294. This Court has held that the plaintiff has the burden of proving any amount of damages with reasonable certainty. *Adams v. U.S. Homecrafters, Inc.,* 744 So.2d 736, 740 (Miss.1999). However, this Court also has noted that "a measure of speculation and conjecture attends even damage proof all would agree reasonably certain." *Wall v. Swilley,* 562 So.2d 1252, 1256 (Miss.1990). This Court has stated that it will not overturn a jury's verdict unless no reasonable juror could find damages in the amount that the jury awarded. *Missala Marine Services,* 861 So.2d 290, 295 (Miss.2003) (citing *Wal–Mart Stores, Inc. v. Johnson,* 807 So.2d 382, 389 (Miss.2001)).

64. Alexander testified that, in the year after Winstead left the hatchery, fish sales were seventy-six percent lower than they had been throughout the company's existence. He opined that the low sales indicated that either Kilby Brake was mismanaged in 2008, or that the sales were under reported by Simmons and Phillips Brothers. To reach the value of the missing fish sales, Alexander found the difference between the average of the gross sales that occurred in 2007 and 2009 versus the gross sales that occurred in 2008: a $591,000 difference. To get to $591,000, Alexander also added a speculative twenty-five percent increase to the price of fingerlings, thus increasing the value of the assets. However, this price increase took place in 2011, long after Winstead filed suit to dissolve Kilby Brake in 2009. Winstead was awarded one-third of Alexander's valuation of the missing fish sales in his corporate freeze-out damages and the other two thirds of this value in his breach-of-fiduciary-duty damages, arguing Simmons and Phillips Brothers received a disgorgement of profits from their breach.

[32] 65. There are several problems with Alexander's valuation of the mismanaged assets which require a new trial on these damages. To calculate lost profits as damages, the lost profits a party must prove are the "net profits as opposed to gross profits." *Ballard Realty Co. Inc. v. Ohazurike,* 97 So.3d 52, 62 (Miss.2012) (quoting *Lovett v. E.L. Garner, Inc.,* 511 So.2d 1346, 1353 (Miss.1987)); *Puckett Machinery Co. v. Edwards,* 641 So.2d 29, 37 (Miss.1994) ("[T]his Court has held that in calculating the loss of profits, the loss to be calculated is that of net profits, not gross profits."). "To ascertain net profits, a party must deduct such items as overhead, depreciation, taxes and inflation." *Lovett,* 511 So.2d at 1353. Alexander testified that he added the $591,000 into the value of Kilby Brake "to account for those fish that should have been there but have not been sold." However, his valuation of the total amount of lost profits from missing fish sales failed to account for items such as overhead, labor, taxes, or debt. Indeed, the valuation simply calculated the gross amount of missing fish sales.

66. Further, Winstead filed suit in September 2009 for, among other things, dissolution of Kilby Brake. In valuing the business, both experts stated at trial that they used the date Winstead filed suit as the valuation date. Inexplicably, Alexander adjusted the price of the missing fish sales by increasing their value by twenty-five percent to "current prices" to account for what he deemed an increase in value from 2009–2011. Any valuation on his right to recover for the 2008 lost fish sales ended the date he filed suit in September of 2009 to dissolve the LLC. *See, e.g., Hollis v. Hill,* 232 F.3d 460, 472 (5th Cir.2000) (holding the presumptive valuation date on a freeze-out claim to be the date of filing the suit). Both experts stated at trial they used that date in their valuation of Kilby Brake. The use of this date will allow the Court to take into account both parties' actions, inactions and business decisions which affected the value of the business from the time Winstead left Kilby Brake until suit was filed. Alexander's calculations were purely speculative in nature and artificially inflated the value of Kilby Brake. Therefore, we are compelled to reverse and remand for a

new trial on issues regarding any breach of fiduciary duty with regard to the loss of fish inventory.

V. Whether Kilby Brake is entitled to a new trial.

[33] 67. During discovery, Winstead produced his tax returns from 2006 to 2009 which showed substantial income as coming from the Winstead Cattle Company. The only other income listed on Winstead's tax returns was from Kilby Brake and his wife's job. Winstead had also produced two Forms 1099 from a fish farmer named Scott Kiker, which did not appear on his tax returns. Kilby Brake's theory was the entries for "cattle" represented income from sales of Kilby Brake fish Winstead was brokering and thus, it sought to compel production of all of the Winstead Cattle Company's financial records. Winstead admitted in his deposition and again at trial that the Winstead Cattle Company did no actual business, and it was simply his hunting camp. The trial court denied Kilby Brake's motion to compel discovery into Winstead's finances.

68. While cross-examining Winstead, counsel for Kilby Brake began to question him about the two Forms 1099 Winstead had produced in discovery showing income from Kiker. Winstead testified that he would often act as a middle man if he knew of a farmer who was in need of fish and another who had fish for sale; taking a commission for brokering the deal. Kilby Brake's counsel was not allowed to question Winstead about where this income from brokering fish sales appeared on the tax returns, because the returns were prepared by Winstead's accountant. The trial court ruled Winstead did not have personal knowledge of the returns and thus, the returns were inadmissable hearsay.

[34][35] 69. A trial court's discovery orders will not be disturbed unless there is an abuse of discretion. *Dawkins v. Redd Pest Control Co., Inc.,* 607 So.2d 1232, 1235 (Miss.1992). This Court said where "important information is denied a litigant reversal will obtain." *Id.* " '[A]dmission or suppression of evidence is within the discretion of the trial judge and will not be reversed absent an abuse of that discretion.' " *Church of God Pentecostal, Inc. v. Freewill Pentecostal Church of God, Inc.,* 716 So.2d 200, 210 (Miss.1998) (citation omitted) (quoting *Sumrall v. Mississippi Power Co.,* 693 So.2d 359, 365 (Miss.1997)). Even if an abuse of discretion has occurred, "for a case to be reversed on the admission or exclusion of evidence, it must result in prejudice and harm or adversely affect a substantial right of a party." *Terrain Enter., Inc. v. Mockbee,* 654 So.2d 1122, 1131 (Miss.1995) (citations omitted).

70. Kilby Brake's attorney made a proffer that he would have questioned Winstead on where the income from Kiker appeared on his income tax return and whether it was indicated under the Winstead Cattle Company entry, because Winstead already had testified Winstead Cattle Company did no business and was merely a hunting camp. Winstead cited *U.S. Fidelity & Guaranty Co. v. Whitfield* as authority for the proposition that it is inadmissible hearsay for a witness who did not prepare a tax return to testify as to that tax return because he lacks personal knowledge. *See U.S. Fid. & Guar. Co. v. Whitfield,* 355 So.2d 307 (Miss.1978). However, this case is easily distinguishable.

71. In *U.S. Fidelity,* the insured's witness, a certified public accountant (CPA), testified as to the amount of the loss the insured sustained after a fire, basing it on the inventory reflected in the insured's federal income tax return. *Id.* at 309. This Court held that, because the witness CPA did not prepare the insured's tax return nor discuss it with the actual preparer, the witness CPA's testimony "was rank hearsay." *Id.* In the case at bar, Kilby Brake was questioning Winstead about his own tax return. The signature line of the federal income tax return, Form 1040, states that, under the penalty of perjury, the signer has examined the return and believes it to be true and complete. Further, any information used by Winstead's accountant in calculating Winstead's income tax return would have come from Winstead. Thus, we find the trial court's decision not to allow Kilby Brake to cross examine Winstead on his tax return because he lacked personal knowledge was error.

72. Winstead argues that, if there were any errors in the trial court's decisions, they were harmless. However, the record indicates a third Form 1099 from Kiker to Winstead was found in the company truck which Winstead returned after the jury verdict against him on Kilby Brake's replevin claim. Further, Kiker testified that he had received a load of

fish from Kilby Brake that Winstead claimed Simmons was going to “drain'em in the ditch.” Kiker testified there was no paperwork on the transaction; that he sold this load of fish, gave Winstead a commission and did not pay Kilby Brake for the sales.

73. From the evidence noted above, we find the trial court's refusal to allow both discovery into the finances of Winstead and questions concerning Winstead Cattle Company on his tax return prevented Kilby Brake and the jury from finding out whether Winstead was selling fish from Kilby Brake and disguising it on his income tax returns, thereby prejudicing Kilby Brake's ability to present its case. What happened to the fish inventory was central to both parties' theories of the case. Importantly, the decisions by the trial court denied Kilby Brake the ability to present its case as to what happened to the fish. The record shows there were years in which Winstead received substantial income from brokering fish sales, almost $20,000 in one year. He admitted that Winstead Cattle Company did no business and was simply his hunting camp, yet it made significant amounts of money. We therefore reverse the trial court's decision to deny discovery into the finances of Winstead and remand for a new trial on Winstead and Kilby Brake's breach-of-fiduciary-duty claims, as they pertain to the missing fish sales. Specifically, Kilby Brake should be allowed discovery into the finances of Winstead concerning outside income and specifically the stated income from Winstead Cattle Company.

VI. Whether Winstead met the requisite elements of slander *per se.*

[36] 74. The jury found Simmons guilty of slander *per se* and awarded Winstead $5,000 on this claim. Simmons argues that Winstead never presented any evidence that he made slanderous statements about Winstead prior to judicial proceedings. Further, Simmons argues no witnesses testified that he published the alleged slanderous statements about Winstead. Finally, Simmons argues truth as a defense and that he was entitled to his opinion of Winstead as a hatchery operator.

[37][38] 75. To prove slander, Winstead had the burden to prove the following elements: (1) a false and defamatory statement concerning the plaintiff; (2) unprivileged publication to a third party; (3) fault amounting to at least negligence on the part of the publisher; and (4) either actionability of the statement irrespective of special harm or the existence of special harm caused by the publication. *Franklin v. Thompson,* 722 So.2d 688, 692 (Miss.1998) (citations omitted). Because publication is an essential element to slander, “if the words were spoken only to the complaining party or to his agent, representing him in the matter discussed ... it is not such a publication as will support an action for slander.” *Kirk Jewelers v. Bynum,* 222 Miss. 134, 75 So.2d 463 (1954).

76. In Mississippi, statements are actionable *per se* if they are:

> (1) Words imputing the guilt or commission of some criminal offense involving moral turpitude and infamous punishment. (2) Words imputing the existence of some contagious disease. (3) Words imputing unfitness in an officer who holds an office of profit or emolument, either in respect of morals or inability to discharge the duties thereof. (4) Words imputing a want of integrity or capacity, whether mental or pecuniary, in the conduct of a profession, trade or business; and in this and some other jurisdictions (5) words imputing to a female a want of chastity.

Speed v. Scott, 787 So.2d 626, 632 (Miss.2001) (quoting *W.T. Farley, Inc. v. Bufkin,* 159 Miss. 350, 132 So. 86, 87 (1931)).

[39][40][41] 77. Further, “[t]he slander ... must be clear and unmistakable from the words themselves and not be the product of any innuendo, speculation or conjecture.” *Baugh v. Baugh,* 512 So.2d 1283, 1285 (Miss.1987). If the language is actionable *per se,* general damages are presumed to result. *McCrory Corp. v. Istre,* 252 Miss. 679, 173 So.2d 640, 646 (1965) (citations omitted). It is well settled that truth is a complete defense to a charge of slander. *Franklin,* 722 So.2d at 692.

[42][43] 78. When analyzing a slander claim, Mississippi courts first determine if "the occasion called for a qualified privilege" and if a qualified privilege does exist, "the Court must then determine whether the privilege is overcome by malice, bad faith, or abuse." *Eckman v. Cooper Tire & Rubber Co.,* 893 So.2d 1049, 1052 (Miss.2005) (citing *Garziano v. E.I. Du Pont De Nemours & Co.,* 818 F.2d 380, 386–87 (5th Cir.1987) (applying Mississippi law)). One of the qualified privileges recognized by this Court protects communications between employers and their employees. *See Holland v. Kennedy,* 548 So.2d 982, 987 (Miss.1989). In speaking of this privilege, this Court held: "[t]he law guards jealously the right to the enjoyment of a good reputation, but public policy, ... the interests of society, and sound business demand that an employer ... be permitted to discuss freely with an employee, or his chosen representative, charges made against the employee affecting the latter's employment." *Killebrew v. Jackson City Lines,* 225 Miss. 84, 82 So.2d 648, 650 (1955). In describing the contours of the employer/employee privilege, this Court held " '[w]hen qualified privilege is established, statements or written communications are not actionable as slanderous or libelous absent bad faith or malice if the communications are limited to those persons who have a legitimate and direct interest in the subject matter.' " *Young v. Jackson,* 572 So.2d 378, 383 (Miss.1990) (quoting *Bush v. Mullen,* 478 So.2d 313 (Miss.1985) (internal citations omitted)).

79. In his amended complaint, Winstead asserted claims for slander and slander *per se* against Simmons. In his count for slander, he accused Simmons of telling members of the catfish farming community that Winstead stole fish from Kilby Brake. In his complaint for slander *per se,* he asserted the statements which were inherently defamatory were the statements adopted in his slander argument. The trial court granted Simmons's motion for a directed verdict on Winstead's slander claim but denied his motion on the slander *per se* claim.

80. No witnesses testified that Simmons told them Winstead was stealing fish from Kilby Brake. The only evidence in the record of Simmons stating Winstead stole fish was when he read his deposition testimony on the stand. Winstead's attorney asked if Simmons had ever used the word stealing when talking about Winstead. Simmons responded "not to my recollection." Winstead's attorney then asked Simmons to read from his prior deposition testimony. Simmons read the relevant portion, in which he stated, "I knew we needed to get out of this situation ... when he was falsifying fish movement tickets ... [i]t was stealing from, from one of my other entities."

81. Although Simmons said Winstead was stealing from Kilby Brake, Winstead did not put on any proof that Simmons published these statements to third parties. Simmons's deposition testimony was about why he fired Winstead. Further, it was in response to a question from Winstead's attorney about why Winstead was fired. Winstead's response was published only to Winstead's chosen representative and regarded charges made against Winstead affecting his employment. Thus, we find no merit in this argument.

82. The other evidence Winstead argues proves his slander *per se* claim developed during trial. Simmons was asked by Winstead's counsel whether he believed that Winstead could not run a successful operation because he was golfing, hunting, drinking, and gambling all of the time. Simmons responded he believed so, and that he probably said that to people. Therefore, the only evidence in front of the jury on this claim was Simmons's own admission that he "probably" expressed his belief to other people. The record does not reveal the identities of these other parties.

83. Testimony from other witnesses indicated that Winstead drank to excess at times, hunted often, golfed, and had gambled in a weekly card game regularly for years. All this occurred while he was working for Kilby Brake. Further, it was undisputed that Kilby Brake was successful for only two of the eight years Winstead was hatchery operator. However, no witness testified that he or she could say Winstead's golfing, hunting, drinking, or gambling interfered with his abilities to operate Kilby Brake.

84. Winstead bore the burden to prove by a preponderance of the evidence that Simmons published the above statements to parties outside of those within the circle of privileged individuals and that these statements were indeed

false. We find that, alone, the statements of Simmons that he probably had expressed his belief to others insufficient for Winstead to carry the burden that Simmons's statement were published to unprivileged third parties or that they were even false. Therefore, we reverse the judgment for slander *per se* and render a decision in favor of Simmons.

CONCLUSION

85. We reverse the judgment of the Yazoo County Circuit Court and remand this case for a new trial on whether Winstead or Kilby Brake is entitled to any damages regarding Winstead's pay and personal charges. In addition, we reverse and remand for a new trial on the breach-of-fiduciary-duty claim as to liability and damages for the missing fish and any damages that may occur as a result. We also reverse and render all claims against Phillips Brothers. Further, we reverse and render the claims for corporate freeze-out and slander *per se* against Simmons. Because we reverse for a new trial, we also reverse all awards of punitive damages, attorneys' fees, and interest.

86. **REVERSED; REMANDED IN PART; RENDERED IN PART.**

Case 2.3

Cleveland Const., Inc. v. Levco Const., Inc.
359 S.W.3d 843, 2012 WL 246497 (Tex.App.-Hous. (1 Dist.))
Court of Appeals of Texas,
Houston (1st Dist.).

CLEVELAND CONSTRUCTION, INC., Appellant
v.
LEVCO CONSTRUCTION, INC., Appellee.

No. 01–11–00530–CV.
Jan. 26, 2012.

OPINION

EVELYN V. KEYES, Justice.

Appellant, Cleveland Construction, Inc. ("CCI"), appeals the trial court's denial of its motion to compel arbitration. In two issues, CCI argues that the trial court erroneously denied its motion to compel arbitration because (1) the Federal Arbitration Act ("FAA") applies, the arbitration provision is valid, and the claim is within the scope of the arbitration provision, and (2) the law favors arbitration and the FAA preempts conflicting state law.

We reverse and remand.

Background

Whole Foods Market, Inc. ("Whole Foods") hired CCI to serve as general contractor to construct a store in Houston, Texas ("the Project"). The contract between Whole Foods and CCI ("the Whole Foods Contract") allowed CCI to hire subcontractors.

CCI contracted with appellee, Levco Construction, Inc. ("Levco"), as a subcontractor, to perform certain tasks related to the construction, including excavating, grading, digging for laying utilities, paving, and preparing the foundation ("the Construction Contract"). The Construction Contract contained the following arbitration provision:

> *Article 30. DISPUTE RESOLUTION*
>
> ....
>
> 30.3 Any controversy or claims of CCI against Subcontractor [Levco] or Subcontractor against CCI shall, at the option of CCI, be resolved by arbitration pursuant to the Construction Industry Arbitration Rules of the American

Arbitration Association in effect on the date on which the demand for arbitration is made. Any such arbitration shall be held in Lake County, Ohio. Any award arising out of such arbitration may be entered by any court having jurisdiction....

Levco also obtained a surety bond ("the Bond") from Intervener, Insurors Indemnity Company ("the Surety"). Both the Whole Foods Contract and the Bond issued by the Surety provided that disputes were to be resolved in a court in the county in which the Project was built, Harris County, Texas. Specifically, the Bond provided, in part:

§ 4 When the Owner [CCI] has satisfied the conditions of Section 3 [requiring notice of Contractor Default and other conditions precedent triggering the Surety's obligations under the Bond], the Surety shall promptly and at the Surety's expense take one of the following actions:

§ 4.1 Arrange for the Contractor [Levco], with consent of the Owner, to perform and complete the Construction Contract; or

§ 4.2 Undertake to perform and complete the Construction Contract itself, through its agents or through independent contractors; or

§ 4.3 Obtain bids or negotiated proposals from qualified contractors acceptable to the Owner for a contract for performance and completion of the Construction Contract ... and to pay to the Owner the amount of damages as described in Section 6 in excess of the Balance of the Contract Price incurred by the Owner resulting from the Contractor's default; or

§ 4.4 Waive its right to perform and complete, arrange for completion, or obtain a new contractor with reasonable promptness under the circumstance....

....

§ 6 After the Owner has terminated the Contractor's right to complete the Construction Contract, and if the Surety elects to act under Section 4.1, 4.2, or 4.3 above, then the responsibilities of the Surety to the Owner shall not be greater than those of the Contractor under the Construction Contract, and the responsibilities of the Owner to the Surety shall not be greater than those of the Owner under the Construction Contract....

....

§ 9 Any proceeding, legal or equitable, under this Bond may be instituted in any court of competent jurisdiction in the location in which the work or part of the work is located and shall be instituted within two years after Contractor Default or within two years after the Contractor ceased working or within two years after the Surety refuses or fails to perform its obligations under this Bond, whichever occurs first....

After Levco had partially performed under the Construction Contract, disputes arose between CCI and Levco concerning the Project, and on, January 17, 2011, CCI sent a letter to Levco informing it that "CCI elects to terminate its Agreement with Levco Construction." The work was subsequently completed by Levco under the provisions of the Bond.

On April 14, 2011, Levco filed suit against CCI and Whole Foods in Texas state court. According to its pleadings, Levco discovered upon beginning the work that CCI and Whole Foods had failed to obtain all necessary construction permits and that the building design and plans were not complete, so Levco was required to make numerous changes. Levco made multiple requests to change the scope of the contracted-for work to include the new work, including requests for additional time and compensation. Levco alleges that CCI and Whole Foods refused to consent to the changes Levco sought. Levco also alleges that CCI maintained unreasonable deadlines, interfered with Levco's work under the Construction Contract, failed to pay Levco for work it had completed from July 2010 to April 2011, and wrongfully terminated the contract in January 2011. Thus, Levco was unable to pay its subcontractors, resulting in liens being filed against the Project.

Levco alleges that CCI eventually reinstated Levco as a subcontractor pursuant to section 4.1 of the Bond, but CCI "continued to refuse to reinstate the [Construction Contract] itself." Levco claims that because CCI refused to reinstate the Construction Contract between them it was left in the position of "working essentially as a subcontractor for the [S]urety" under the terms of the Bond. Specifically, Levco alleges that, in its role as the issuer of the Bond, the Surety mandated that Levco be allowed to continue to work on the Project, as provided in section 4.1 of the Bond, and made an agreement with CCI regarding payment of Levco and Levco's subcontractors, as provided in section 6 of the Bond. Levco alleges that the Surety and CCI agreed that the Surety would pay Levco's subcontractors money owed them in exchange for CCI releasing the corresponding payments it owed Levco once the subcontractors released their liens on the Project. Levco states that the Surety complied with this agreement and paid Levco's subcontractors, but that CCI did not comply and release the money it owed Levco or Levco's subcontractors. Nor did CCI reinstate the Construction Contract it had terminated. Levco contends that CCI and Whole Foods are “now improperly withholding more than $500,000 in funds owed to Levco.”

Levco claims that CCI breached its agreement with Levco; that CCI and Whole Foods breached their duties to perform with care in accordance with the terms of the Construction Contract (as provided in both the Construction Contract and section 6 of the Bond) and the Whole Foods Contract and to cooperate in performance of the contracts; that CCI and Whole Foods owe it damages under theories of quantum meruit, unjust enrichment, and promissory estoppel; that CCI and Whole Foods violated Property Code section 28.001; and that CCI misapplied trust funds received from Whole Foods for payment of obligations under the Construction Contract and the Bond.

In addition, Levco sought a declaratory judgment that the arbitration clause in the Construction Contract is invalid and does not require arbitration because it is illusory, or, alternatively, that the provision in the Construction Contract requiring arbitration in Ohio is void because it contravenes Texas law in that “it purports to require a subcontractor to a contract involving the improvement or real property in Texas to submit to arbitration in a state other than Texas.” Finally, Levco sought attorney's fees pursuant to Civil Practice and Remedies Code section 37.009 and chapter 38 and Property Code section 28.005, and it sought a temporary restraining order or temporary injunction prohibiting CCI and Whole Foods from releasing any funds related to the Project.

On April 14, the trial court granted Levco's temporary restraining order until April 29, 2011, and it set a hearing on Levco's request for a temporary injunction for April 29.

CCI filed an arbitration demand with the American Arbitration Association, alleging, under “nature of the dispute,”

> Respondent [Levco] is a subcontractor to Claimant [CCI] on the construction of a Whole Foods Market located in Houston, Texas (“Project”). Levco breached the subcontract and was terminated by CCI. Levco was bonded on the Project and the surety, Insurer's Indemnity Company utilized its option to have Levco complete the work on the Project; however, further breaches have occurred [and] CCI has been damaged by Levco's breach in [an] amount not yet fully determined but in [an] amount that CCI does not anticipate will exceed $150,000.

CCI requested that Lake County, Ohio be the arbitration locale.

On April 26, 2011, Levco filed an emergency motion to stay the arbitration proceeding.

On May 11, 2011, CCI answered Levco's suit with a general denial and asserted the affirmative defenses that a valid contract precluded Levco's quantum meruit claims, that CCI had paid Levco under the Construction Contract, that Levco failed to meet all conditions precedent to payment under the Construction Contract, that CCI was entitled to the defenses of “excuse” and “justification,” and that Levco lacked standing to assert its claims against CCI, had failed to state a claim for which relief can be granted, and was the first to breach the Construction Contract.

CCI alleged that Levco defaulted under the Construction Contract within a month after beginning the Project and that CCI issued notices of default on multiple dates following. CCI attached several of these notices to its answer. It also alleged that “Levco was upside down on the Project from the beginning and failed to pay its vendors and suppliers in a timely manner” and that “Levco's financial mismanagement caused numerous, unnecessary liens on the Project.” CCI also attached several notices from “lower tier” subcontractors claiming they had not been paid by Levco. This led CCI to terminate Levco from the Project in January 2011 and to notify the Surety of Levco's breach.

CCI alleged that the Surety elected its option under the terms of the Bond to arrange “for Levco to perform and complete its obligations under the Contract.” CCI argues that “[b]y selecting this option, [the Surety] undertook Levco's obligations under the Contract and CCI was to reciprocally perform its obligations directly to [the Surety] ... and, as required by the Performance Bond, any money currently owed by CCI must be paid to [the Surety], not Levco.” CCI also alleged that it agreed to 26 of the 31 change orders submitted by Levco and that it offered to pay the Surety the outstanding pay applications if Levco would execute a release, which Levco refused to do.

CCI also responded to Levco's application for a temporary injunction and moved to compel arbitration and to stay the trial court proceedings, or alternatively, to dismiss the trial court proceedings.

In its motion to compel arbitration, also filed on May 11, CCI argued that the arbitration clause between it and Levco was valid, that it was not illusory or in contravention of Texas state law, and that the dispute at issue fell within the scope of the agreement. CCI also argued that the FAA preempts Levco's claim based on Business and Commerce Code section 272.001. Levco responded that the arbitration clause was invalid and illusory and that it failed to survive termination of the Construction Contract.

On May 26, 2011, the Surety filed a plea in intervention, arguing that "mandatory jurisdiction and venue with respect to the claims and causes of action asserted by Intervenor against [CCI] herein properly lie in this Court pursuant to the express provisions of § 9" of the Bond. It likewise alleged that, after CCI terminated the Contract between itself and Levco, CCI called upon it, as Surety, to complete Levco's obligations pursuant to the Bond. The Surety alleged that it elected to utilize Levco to continue performance of the subcontract work with the Surety itself advancing Levco's payroll and certain of its overhead expenses, as provided in section 4.1 of the Bond. In exchange, CCI agreed to pay to the Surety "all remaining monies due and owing or to become due and owing under the Levco Subcontract Agreement," in accordance with section 6 of the Bond.

The Surety alleged that CCI subsequently breached this agreement by failing to make those payments. It alleged that it had expended $983,790.49 and that "under the express provisions of Levco's General Indemnity Agreement and pursuant to [its] common law rights to indemnity and equitable subrogation, [the Surety] has a superior lien upon and is entitled to payment directly from CCI on any and all contract sums or compensatory damages adjudged by this Court to be due and owing ... to Levco and/or [the Surety]."

On May 27, 2011, the trial court granted Levco's emergency motion to stay the arbitration proceeding initiated by CCI. This appeal followed.

Analysis

CCI argues that the trial court erred in denying its motion to compel arbitration because the FAA applies, the arbitration provision in the Construction Contract is valid, and the claims in the case are within the scope of the arbitration provision. It also argues that the FAA preempts any conflicting state law. Levco, however, argues that the arbitration provision in the Construction Contract is illusory and, therefore, unenforceable as a matter of law; that the Construction Contract was terminated and the arbitration provision does not contain a survival clause that would allow it to survive termination of the contract; and that Business and Commerce Code section 272.001 is not preempted by the FAA because it restricts venue, rather than restricting a party's right to arbitrate.

A. Jurisdiction

We first address our jurisdiction to review the trial court's order staying the arbitration proceedings. Civil Practice and Remedies Code section 51.016 provides:

> In a matter subject to the Federal Arbitration Act (9 U.S.C. Section 1 et seq.), a person may take an appeal or writ of error to the court of appeals from the judgment or interlocutory order of a district court, county court at law, or county court under the same circumstances that an appeal from a federal district court's order or decision would be permitted by 9 U.S.C. Section 16.

TEX. CIV. PRAC. & REM.CODE ANN. § 51.016 (Vernon Supp. 2011). Section 16 of the FAA, "Appeals," provides:

> (a) An appeal may be taken from—
>
> (1) an order—
>
> (A) refusing a stay of any action under section 3 of this title [stay of trial proceedings where issue therein is referable to arbitration],
>
> (B) denying a petition under section 4 of this title to order arbitration to proceed, [or]
>
> (C) denying an application under section 206 of this title to compel arbitration....
>
> (2) an interlocutory order granting, continuing, or modifying an injunction against an arbitration that is subject to this title; or
>
> (3) a final decision with respect to an arbitration that is subject to this title.
>
> (b) Except as otherwise provided in section 1292(b) of title 28, an appeal may not be taken from an interlocutory order—
>
> (1) granting a stay of any action under section 3 of this title;
>
> (2) directing arbitration to proceed under section 4 of this title;
>
> (3) compelling arbitration under section 206 of this title; or

(4) refusing to enjoin an arbitration that is subject to this title.

9 U.S.C. § 16 (2006).

[1] Thus, an interlocutory appeal is permitted in this case only if it would be permitted under the same circumstances under section 16 of the FAA in federal court. *See CMH Homes v. Perez,* 340 S.W.3d 444, 448–49 (Tex.2011). The United States Supreme Court has held that the FAA "generally permits immediate appeal of orders hostile to arbitration." *Green Tree Fin. Corp.-Ala. v. Randolph,* 531 U.S. 79, 86, 121 S.Ct. 513, 519, 148 L.Ed.2d 373 (2000). Several circuit courts have held that the FAA permits interlocutory review of an order staying arbitration. *Arciniaga v. Gen. Motors Corp.,* 460 F.3d 231, 234 (2nd Cir.2006) (holding FAA subsection 16(a)(2) permits interlocutory review of stay of arbitration); *KKW Enters., Inc. v. Gloria Jean's Gourmet Coffees Franchising Corp.,* 184 F.3d 42, 47 (1st Cir.1999) (holding that order staying pending arbitration was immediately appealable as injunction under both 28 U.S.C. § 1292(a)(1) and FAA section 16(a)(2)); *Se. Res. Recovery Facility Auth. v. Montenay Int'l Corp.,* 973 F.2d 711, 712 (9th Cir.1992) (holding it had jurisdiction over district court's order staying arbitration pursuant to section 16(a)(2) allowing appeal from an order enjoining arbitration). Furthermore, the Fifth Circuit has held that an order granting a stay of arbitration is appealable pursuant to 28 U.S.C. § 1292(a)(1), governing appeals of interlocutory orders involving injunctions generally. *See Tai Ping Ins. Co. v. M/V Warschau,* 731 F.2d 1141, 1143 (5th Cir.1984).

B. Standard of Review

Prior to September 1, 2009, an order denying a motion to compel arbitration under the FAA was reviewed in a mandamus proceeding using an abuse of discretion standard. *In re Merrill Lynch & Co.,* 315 S.W.3d 888, 890–91 & n. 3 (Tex.2010) (orig. proceeding); *Jack B. Anglin Co. v. Tipps,* 842 S.W.2d 266, 272–73 (Tex.1992) (orig. proceeding). The Texas Supreme Court held that the abuse of discretion standard, as applied to such orders, required reviewing courts to defer to the trial court's factual determinations if they are supported by the evidence and to review the trial court's legal determinations de novo. *In re Labatt Food Serv., L.P.,* 279 S.W.3d 640, 643 (Tex.2009) (orig. proceeding). This is the same standard by which we review interlocutory appeals of orders denying motions to compel arbitration under the Texas Arbitration Act ("TAA"). *See McReynolds v. Elston,* 222 S.W.3d 731, 739 (Tex.App.-Houston [14th Dist.] 2007, no pet.) (holding, under TAA, "we review factual conclusions under a legal sufficiency or 'no evidence' standard and legal conclusions de novo"); *see also In re Trammell,* 246 S.W.3d 815, 820 (Tex.App.-Dallas 2008, no pet.) (orig. proceeding) (holding same).

Civil Practice and Remedies Code section 51.016 now permits an order denying a motion to compel arbitration under the FAA to be reviewed via interlocutory appeal. TEX. CIV. PRAC. & REM.CODE ANN. § 51.016. Neither this Court nor the Texas Supreme Court has addressed the appropriate standard of review for such interlocutory appeals. However, various courts of appeals have considered this issue and held that interlocutory appeals of orders denying motions to compel arbitration should be reviewed under the abuse of discretion standard, in which we defer to the trial court's factual determinations and review questions of law de novo. *See Garcia v. Huerta,* 340 S.W.3d 864, 868–69 (Tex.App.-San Antonio 2011, pet. filed); *SEB, Inc. v. Campbell,* No. 03–10–00375–CV, 2011 WL 749292, at *2 (Tex.App.-Austin Mar. 2, 2011, no pet.) (mem. op.); *Sidley Austin Brown & Wood, LLP v. J.A. Green Dev. Corp.,* 327 S.W.3d 859, 862–63 (Tex.App.-Dallas 2010, no pet.); *see also Torster v. Panda Energy Mgmt., LP,* No. 07–10–0442–CV, 2011 WL 780522, at *2 (Tex.App.-Amarillo Mar. 7, 2011, pet. filed) (mem. op) (citing *Sidley, Austin, Brown & Wood* in holding that whether trial court erred in denying motion to compel arbitration "depends on whether it abused its discretion").

[2] Thus, in reviewing an order denying a motion to compel arbitration under the FAA, we give deference to the trial court's factual determinations that are supported by evidence and we review de novo its legal conclusions.

[3][4] A party seeking to compel arbitration under the FAA must establish that there is a valid arbitration agreement and that the claims raised fall within that agreement's scope. *In re Kellogg Brown & Root, Inc.,* 166 S.W.3d 732, 737 (Tex.2005) (orig. proceeding); *J.M. Davidson, Inc. v. Webster,* 128 S.W.3d 223, 227 (Tex.2003). If the trial court finds a valid agreement, the burden shifts to the party opposing arbitration to raise an affirmative defense to enforcing arbitration. *J.M. Davidson,* 128 S.W.3d at 227. The trial court's determination as to the validity of an arbitration agreement is a legal determination that we review de novo. *Id.*

[5][6][7] Under the FAA, ordinary principles of state contract law determine whether there is a valid agreement to

arbitrate. *Kellogg Brown & Root,* 166 S.W.3d at 738. Although there is a strong presumption favoring arbitration, that presumption arises only after the party seeking to compel arbitration proves that a valid arbitration agreement exists. *J.M. Davidson,* 128 S.W.3d at 227. Because arbitration is contractual in nature, the FAA generally does not require parties to arbitrate when they have not agreed to do so. *Kellogg Brown & Root,* 166 S.W.3d at 738 (quoting *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ.,* 489 U.S. 468, 478–79, 109 S.Ct. 1248, 1255, 103 L.Ed.2d 488 (1989)).

C. Determination of Existence of Valid Agreement to Arbitrate

CCI argues that the arbitration clause in the Construction Contract is a valid and binding agreement to arbitrate. Levco, however, argues that it is illusory and unenforceable as a matter of law. Levco also argues that, even if the agreement to arbitrate in the Construction Contract is not illusory, the arbitration agreement in the Construction Contract does not contain a survival clause that would allow it to survive termination of the contract.[FN1]

[8][9][10] In determining the validity of agreements to arbitrate that are subject to the FAA, we generally apply ordinary state contract law principles. *In re Palm Harbor Homes, Inc.,* 195 S.W.3d 672, 676 (Tex.2006) (orig. proceeding). The elements of a valid contract are (1) an offer, (2) an acceptance, (3) a meeting of the minds, (4) each party's consent to the terms, and (5) execution and delivery of the contract with the intent that it be mutual and binding. *Prime Prods., Inc. v. S.S.I. Plastics, Inc.,* 97 S.W.3d 631, 636 (Tex.App.-Houston [1st Dist.] 2002, pet. denied). “Under generally accepted principles of contract interpretation, all writings that pertain to the same transaction will be considered together, even if they were executed at different times and do not expressly refer to one another.” *DeWitt Cnty. Elec. Coop., Inc. v. Parks,* 1 S.W.3d 96, 102 (Tex.1999); *IP Petroleum Co. v. Wevanco Energy, L.L.C.,* 116 S.W.3d 888, 889 (Tex.App.-Houston [1st Dist.] 2003, pet. denied) (“Instruments pertaining to the same transaction may be read together to ascertain the parties' intent, even if the parties executed the instruments at different times.”) (citing *Fort Worth Indep. Sch. Dist. v. City of Fort Worth,* 22 S.W.3d 831, 840 (Tex.2000)); *see also DeClaire v. G & B McIntosh Family Ltd. P'Ship,* 260 S.W.3d 34, 44 (Tex.App.-Houston [1st Dist.] 2008, no pet.) (holding that contract can be effective if signed by only one party if other party accepts by his acts, conduct, or acquiescence in the terms of the contract).

CCI presented the Construction Contract, which provides, in part:

> Any controversy or claims of CCI against Subcontractor [Levco] or Subcontractor against CCI shall, at the option of CCI, be resolved by arbitration pursuant to the Construction Industry Arbitration Rules of the American Arbitration Association in effect on the date on which the demand for arbitration is made. Any such arbitration shall be held in Lake County, Ohio.

CCI argues that this is a valid arbitration agreement. However, Levco argues, both here and in the trial court, that the arbitration agreement in the Construction Contract is not valid because it is illusory.[FN2]

D. Analysis of Levco's Claims that Abritration Provision is Illusory

[11][12][13] “A promise is illusory if it does not bind the promisor, such as when the promisor retains the option to discontinue performance.” *In re 24R, Inc.,* 324 S.W.3d 564, 567 (Tex.2010) (orig. proceeding) (per curiam); *see also J.M. Davidson,* 128 S.W.3d at 235 (Schneider, J., dissenting) (“[I]f the terms of a promise make performance optional, the promise is illusory and cannot constitute valid consideration.”). Arbitration agreements must be supported by consideration, or mutuality of obligation, to be enforceable. *Palm Harbor Homes,* 195 S.W.3d at 676; *Dorfman v. Max Int'l, LLC,* No. 05–10–00776–CV, 2011 WL 1680070, at *2 (Tex.App.-Dallas May 5, 2011, no pet.) (mem. op.).

[14] In the context of stand-alone arbitration agreements, binding promises are required on both sides as they are the only consideration rendered to create a contract. *In re AdvancePCS Health L.P.,* 172 S.W.3d 603, 607 (Tex.2005) (orig. proceeding) (per curiam); *Dorfman,* 2011 WL 1680070, at *2. When, however, an arbitration clause is part of an underlying contract, the rest of the parties' agreement provides the consideration. *AdvancePCS Health,* 172 S.W.3d at 607; *see Palm Harbor Homes,* 195 S.W.3d at 676–77.

Here, the plain language of the arbitration provision does not mutually bind the parties because arbitration is “at the option of CCI.” However, this arbitration provision does not stand alone—it is part of an underlying contract. Thus, consideration, or the presence of mutual obligation, is provided by the underlying contract. *See AdvancePCS Health,* 172 S.W.3d at 607.

Levco seems to argue that the underlying contract does not provide any consideration for the arbitration provision because it, too, permits CCI to terminate, suspend, or modify its terms at its sole discretion, without notice. Levco's reliance on those provisions of the Construction Contract is misplaced. The modification provision's plain language does not state that CCI is the only party that can modify the agreement—it provides only that any modifications must be signed by CCI's representative to be effective. Furthermore, while the Construction Contract provides that termination or suspension will be "at the sole option and convenience to CCI," the contract also provides that CCI must pay for work and materials already purchased at the time it gives notice of such termination or suspension. Thus, the parties are bound by mutual obligations and the agreement is not illusory.

E. Analysis of Levco's Termination and Savings Clause Argument

Levco also argues that CCI is complaining of work primarily completed after CCI terminated the Construction Contract and that the dispute resolution clause in the Construction Contract cannot survive the termination because it did not contain a savings clause.

[15] "[A]n arbitration agreement contained within a contract survives the termination or repudiation of the contract as a whole." *Henry v. Gonzalez,* 18 S.W.3d 684, 690 (Tex.App.-San Antonio 2000, pet. dism'd) (relying, in context of TAA, on line of reasoning that agreement to arbitrate contained in written contract is separable from entire contract); *see also In re Koch Indus., Inc.,* 49 S.W.3d 439, 445 (Tex.App.-San Antonio 2001, orig. proceeding) (holding same in context of FAA). Thus, a savings clause was not required for the arbitration provision in the Construction Contract to survive any termination by CCI.

[16] To the extent that Levco is attempting to argue that the dispute between the parties does not fall within the scope of the arbitration provision in the Construction Contract because some of the dispute between itself and CCI arose from work that was completed after CCI terminated the Construction Contract, this is also unavailing. The terms of the Bond expressly incorporate the terms of the Construction Contract. Section 4.1, the provision invoked by the Surety, allows it to "[a]rrange from the Contractor [Levco] ... to perform and complete the Construction Contract." Section 6 of the Bond further states that if the Surety elects to act under section 4.1, "the responsibilities of the Surety to the Owner [CCI] shall not be greater than those of the Contractor under the Construction Contract, and the responsibilities of the Owner to the Surety shall not be greater than those of the Owner under the Construction Contract." Thus, the terms of the Bond expressly provided for Levco to complete the work under the terms of the Construction Contract even after CCI's termination of the contract.

We conclude that CCI proved, as a matter of law, the existence of a valid arbitration agreement and that the claims between it and Levco fall within the scope of that agreement. Thus, CCI is entitled to arbitrate these claims, and the trial court abused its discretion in refusing to enforce the arbitration proceedings. *See, e.g., Jack B. Anglin Co.,* 842 S.W.2d at 272–73 (recognizing, prior to enactment of Civil Practice and Remedies Code section 51.016, appropriateness of mandamus relief "[w]hen a Texas court enforces or refuses to enforce an arbitration agreement pursuant to the [FAA]" because that party "would be deprived of the benefits of the arbitration clause it contracted for, and the purpose of providing a rapid, inexpensive alternative to traditional litigation would be defeated"); *see also In re Bruce Terminix Co.,* 988 S.W.2d 702, 704 (Tex.1998) (orig. proceeding) (holding there is no adequate remedy by appeal for denial of right to arbitration "because the very purpose of arbitration is to avoid the time and expense of a trial and appeal").

FAA Preemption of State Law Venue Provision

Finally, Levco argues that we should "affirm the trial court's denial of [CCI's] Motion to Compel because the Texas Business and Commerce Code section 272.001 prohibits compelling Levco to arbitration in Lake County, Ohio and is not preempted by the [FAA]." It argues that the arbitration must take place in Harris County.

Business and Commerce Code section 272.001 provides:

> If a contract contains a provision making the contract or any conflict arising under the contract subject to another state's law, litigation in the courts of another state, or arbitration in another state, that provision is voidable by the party obligated by the contract to perform the construction or repair.

TEX. BUS. & COM.CODE ANN. § 272.001(b) (Vernon 2006). Levco argues in its appellate brief that it "exercised its option to void the requirement in the Contract to arbitrate in Lake County, Ohio" and, "[a]s a result, the trial court properly denied [CCI's] motion to compel arbitration in Lake County, Ohio." It further argues that if this Court narrowly construes the word "provision" to mean only the choice of venue rather than the arbitration clause as a whole, this statute would not fall under the FAA's preemption provision.

[17][18][19] The FAA preempts all otherwise applicable inconsistent state laws, including any inconsistent provisions of the TAA, under the Supremacy Clause of the United States Constitution. U.S. CONST. art. VI; *see Allied–Bruce Terminix Co. v. Dobson,* 513 U.S. 265, 272, 115 S.Ct. 834, 838, 130 L.Ed.2d 753 (1995). The FAA declares written provisions for arbitration "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (2006); *OPE Int'l LP v. Chet Morrison Contractors, Inc.,* 258 F.3d 443, 446 (5th Cir.2001). "In enacting § 2 of the [FAA], Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *OPE Int'l,* 258 F.3d at 446 (quoting *Southland Corp. v. Keating,* 465 U.S. 1, 10, 104 S.Ct. 852, 79 L.Ed.2d 1 (1984) and *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.,* 460 U.S. 1, 24, 103 S.Ct. 927, 941, 74 L.Ed.2d 765 (1983) ("Section 2 is a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary.")).

In *OPE International,* the Fifth Circuit held that a Louisiana provision invalidating arbitration of certain disputes out-of-state was preempted by the FAA, on the ground that the statute "condition[ed] the enforceability of arbitration agreements on selection of a Louisiana forum; a requirement not applicable to contracts generally." *Id.* at 447; *see also Commerce Park at DFW Freeport v. Mardian Constr. Co.,* 729 F.2d 334, 337 (5th Cir.1984) (holding that FAA preempted provisions in Texas Deceptive Trade Practices Act that required parties to submit to judicial forum).

We hold that the same reasoning applies here. Applying section 272.001 as Levco asks us to do here would prevent us from enforcing a term of the parties' arbitration agreement—the venue—on a ground that is not recognized by the FAA or by general state-law contract principles. *See OPE Int'l,* 258 F.3d at 447; *see also KKW Enters., Inc.,* 184 F.3d at 50 ("The venue in which arbitration is to take place is a 'term' of the parties' arbitration agreement."). We hold that the FAA preempts application of this provision under the facts of this case.

Levco argues that this case is distinguishable from *OPE International* because the Louisiana provision in *OPE International* "declare [d] null and void and unenforceable" any non-Louisiana venue provision, while section 272.001 declares such provisions only "voidable." However, by allowing a party to subsequently declare void a previously bargained-for provision, application of section 272.001 would undermine the declared federal policy of rigorous enforcement of arbitration agreements. *See Perry v. Thomas,* 482 U.S. 483, 490, 107 S.Ct. 2520, 2526, 96 L.Ed.2d 426 (1987) (analyzing section 2 and holding that it embodies Congress' intent to provide for enforcement of arbitration agreements within full reach of the Commerce Clause" and that "[i]t's general applicability reflects that the preeminent concern of Congress ... was to enforce private agreements into which parties had entered").

Conclusion

We reverse the order of the trial court and remand the case for further proceedings consistent with this opinion.

FN1. Levco's appellate brief mentions in passing that the dispute resolution provision in the Bond conflicts with the terms of the Construction Contract. However, it cites no authority and provides no legal analysis on this issue. Therefore, to the extent Levco is attempting to argue that the terms of the Bond prevent arbitration of its dispute with CCI over the claims arising from the Construction Contract, that issue is waived for lack of briefing. *See* TEX.R.APP. P. 38.1(i) (requiring that appellate "brief must contain a clear and concise argument for the contention made, with appropriate citations to authorities" for party to assert issue on appeal); *Brown v. Hearthwood II Owners Ass'n.,* 201 S.W.3d 153, 161 (Tex.App.-Houston [14th Dist.] 2006, pet. denied) (holding argument can be waived for failure to adequately brief).

Levco also argues that the Surety is a necessary party to any arbitration proceeding. However, the Surety is not before this Court as a party to the appeal, nor was it a party to the motion to stay arbitration in the trial court. Thus, we are not called upon to consider the Surety's obligations or rights regarding arbitration.

FN2. CCI argues that we cannot consider Levco's arguments concerning termination of the agreement and subsequent performance under the terms of the Bond because it was not expressly presented to the trial court. This argument is unpersuasive. When, as here, no findings of fact and conclusions of law are filed by the trial court, we must affirm the trial court's order if any legal theory supports it. *Rachal v. Reitz,* 347 S.W.3d 305, 308 (Tex.App.-Dallas 2011, pet. filed). Levco, CCI, and the Surety all informed the trial court of the January 2011 termination by CCI and of the subsequent arrangements under the terms of the Bond, so the trial court was aware of this information.

Supplemental Case Printout for: *Online Developments*

C.D.Cal.,2007.
Columbia Pictures Industries v. Bunnell
Not Reported in F.Supp.2d, 2007 WL 2080419 (C.D.Cal.)
United States District Court,
C.D. California.

COLUMBIA PICTURES INDUSTRIES, et al., Plaintiff,
v.
Justin BUNNELL, et al., Defendants.

No. CV 06-1093FMCJCX.
May 29, 2007.
CHOOLJIAN, Magistrate J.
I. SUMMARY

***1** Pending before the court are (1) plaintiffs' motion to require defendants to preserve and produce certain electronic data, and for evidentiary sanctions, based upon defendants' failure to date to preserve and produce such data; and (2) defendants' request for attorneys' fees and costs.

Based upon the court's consideration of the extensive arguments and evidence presented, the court's assessment of the credibility of the declarants and witnesses who testified at the evidentiary hearing in this matter, and the applicable law, the court finds: (1) the data in issue is extremely relevant and within the scope of information sought by plaintiffs' discovery requests; (2) the data in issue which was formerly temporarily stored in defendants' website's random access memory ("RAM") constituted "electronically stored information" and was within the possession, custody and control of defendants; (3) the data in issue which is currently routed to a third party entity under contract to defendants and received in said entity's RAM, constitutes "electronically stored information," and is within defendants' possession, custody or control by virtue of defendants' ability to manipulate at will how the data in issue is routed; [FN1] (4) defendants have failed to demonstrate that the preservation and production of such data is unduly burdensome, or that the other reasons they articulate justify the ongoing failure to preserve and produce such data; (5) defendants must preserve the pertinent data within their possession, custody or control and produce any such data in a manner which masks the Internet Protocol addresses ("IP addresses") of the computers used by those accessing defendants' website; (6) sanctions against defendants for spoliation of evidence are not appropriate in light of the lack of precedent for requiring the retention of data in RAM, the lack of a preservation request specifically directed to data present only in RAM, and the fact that defendants' failure to retain such data did not violate any preservation order; and (7) awarding attorneys' fees and costs are not appropriate.

> FN1. It may also be the case that the data in issue is within defendants' possession, custody and control by virtue of defendants' contractual relationship with the third party entity. In that circumstance, defendants would, at a minimum, have an obligation to make reasonable inquiry of the third party entity for the data in issue. *See A. Farber and Partners, Inc. v. Garber,* 234 F.R.D. 186, 189 (C.D.Cal.2006).

II. PROCEDURAL HISTORY

On February 23, 2006, plaintiffs filed a complaint against defendants for copyright infringement. Plaintiffs allege, *interalia,* that defendants knowingly enable, encourage, induce, and profit from massive online piracy of plaintiffs' copyrighted works through the operation of their internet website. The complaint is predicated on theories of contributory infringement, secondary infringement, and inducement. Defendants filed an Answer on May 24, 2006.

On March 12, 2007, plaintiffs filed a "Notice of Motion and Local Rule 37-1 Joint Stipulation Regarding Plaintiffs' Motion for an

Order (1) Requiring Defendants to Preserve and Produce Certain Server Log Data, and (2) for Evidentiary Sanctions" ("Plaintiffs' Motion"), a declaration of plaintiffs' counsel Duane C. Pozza ("Pozza I Decl."), a declaration of plaintiffs' expert Ellis Horowitz ("Horowitz I Decl."), a declaration of defendants' counsel Ira P. Rothken, and a declaration of defendant Wes Parker ("Parker I Decl."), as well as accompanying exhibits to each declaration. Plaintiffs' Motion requests that the court issue an order requiring defendants to preserve and produce certain data responsive to plaintiffs' First Request for Production of Documents, Request Nos. 10 and 12.[FN2]Specifically, plaintiffs seek the preservation and production of the following data: (a) the IP addresses of users of defendants' website who request "dot-torrent" files; (b) the requests for "dot-torrent files"; and (c) the dates and times of such requests (collectively "Server Log Data").[FN3] Plaintiffs' Motion also seeks evidentiary sanctions against defendants for their alleged spoliation of the Server Log Data. Defendants request that the court require plaintiffs to pay reasonable expenses incurred in opposing Plaintiffs' Motion, including attorneys' fees, pursuant to F.R. Civ. P. 37(a)(4)(B).

FN2. Request No. 10 seeks "all documents that identify the dot-torrent files that have been made available by, searched for, or downloaded by users of TorrentSpy, including documents that identify the users who have made available, searched for, or downloaded such dot-torrent files."Request No. 12 seeks "all documents, including server logs, databases of a similar nature, or reports derived from such logs or databases that [defendants] maintain, have ever maintained, or have available that record the activities of TorrentSpy or its users, including documents concerning ... Electronic communications of any type between TorrentSpy and [users]; ... Logs of user activities; and ... Logs or records of dot-torrent files made available, uploaded, searched for, or downloaded on TorrentSpy."

FN3. As the Server Log Data is temporarily stored in RAM and constitutes a document that identifies dot-torrent files that have, at a minimum, been searched for by users of TorrentSpy, it is encompassed by Document Request No. 10. Similarly, as the Server Log Data constitutes an available document concerning electronic communications between TorrentSpy and users and a record of dot-torrent files made available or searched for on TorrentSpy, it is also encompassed by Document Request No. 12.

***2** On March 20, 2007, plaintiffs filed a supplemental memorandum in support of Plaintiffs' Motion ("Plaintiffs' Supp. Memo I"), a supplemental declaration of Duane C. Pozza, and accompanying exhibits. On the same date, defendants filed a supplemental memorandum in opposition to Plaintiffs' Motion ("Defendants' Supp. Memo I") and a supplemental declaration of Wes Parker ("Parker II Decl.").

On March 21, 2007, the court directed the parties to file additional items. On March 27, 2007, plaintiffs filed a supplemental brief ("Plaintiffs' Supp. Memo II") and another declaration of Ellis Horowitz ("Horowitz II Decl."), and defendants filed a supplemental brief ("Defendants' Supp. Memo II"), a joint declaration of Justin Bunnell and Wes Parker ("Jt. Bunnell/Parker Decl."), and accompanying exhibits. On March 30, 2007, in response to the court's request that the parties submit statements as to whether certain declarants should attend and be available to testify at the hearing on this matter, the parties each submitted brief additional filings.

On April 3, 2007, the court held an evidentiary hearing at which declarants Ellis Horowitz, Wesley Parker, and Justin Bunnell testified, and the court heard the arguments of counsel.[FN4]The court took Plaintiffs' Motion under submission at the conclusion of the hearing.[FN5]

FN4. "RT" refers to the Reporter's Transcript of the April 3, 2007 hearing.

FN5. Subsequent to the hearing, plaintiffs and defendants submitted proposed findings regarding Plaintiffs' Motion for the court's consideration.

III. FACTS [FN6]

FN6. The court finds plaintiffs' expert Ellis Horowitz to be the most credible of the three technical declarants/witnesses (*i.e.,* Horowitz, Parker, and Bunnell). To the extent the testimony and statements of Parker and Bunnell conflict with those of Horowitz, the court accepts the testimony and statements of Horowitz. The court finds that defendant Parker's testimony is credible in part and gives it some weight. However, as discussed below, the court finds that portions of Parker's declarations and testimony are unsupported and not credible. The court finds that defendant Bunnell's testimony is largely unsupported and lacks credibility.

Defendants operate a website known as "TorrentSpy" which offers dottorrent files for download by users. (Horowitz I Decl. ¶ 5). The dot-torrent files offered on defendants' website do not contain actual copies of a full-length content item. (Horowitz I Decl. ¶ 6). Rather, they contain data used by a "BitTorrent client" on a user's computer to access the content in issue. (Horowitz I Decl. ¶ 6).

As certain aspects of the technical operation of the website are relevant to the resolution of this matter, the court first sets forth its understanding and findings, based upon the evidence presented, of the operation of the relevant aspects of: (i) websites in general; (ii) defendants' website prior to the filing of Plaintiffs' Motion; and (iii) defendants' website proximate or subsequent to the filing of Plaintiffs' Motion, as the record reflects that the method of operation changed during the pendency of this action.

A. Operation of Websites in General

In general, when a user clicks on a link to a page or a file on a website, the website's web server program receives from the user a request for the page or the file. (Horowitz I Decl. ¶ 11; Horowitz II Decl. ¶ 3). The request includes the IP address of the user's computer, and the name of the requested page or file, among other things.[FN7](Horowitz I Decl. ¶ 11; Horowitz II Decl. ¶ 3). Such information is copied into and stored in RAM. (Horowitz II Decl. ¶ 4). RAM is a form of temporary storage that every computer uses to process data. (Horowitz II Decl. ¶ 4). Every user request for a page or file is stored by the web server program in RAM in this fashion. (Horowitz II Decl. ¶ 4). The web server interprets and processes that data, while it is stored in RAM, in order to respond to user requests. (Horowitz II Decl. ¶ 4). The web server then satisfies the request by sending the requested file to the user. (Horowitz II Decl. ¶ 3). If the website's logging function is enabled, the web server copies the request into a log file, as well as the fact that the requested file was delivered. (Horowitz I Decl. ¶ 12; Horowitz II Decl. ¶ 3). If the logging function is not enabled, the request is not retained. (Horowitz I Decl. ¶ 12; Horowitz II Decl. ¶ 3). While logging such information can be useful to a website operator in many respects, and may be a usual practice of many website operators, such logging is not essential to the functionality of a website.[FN8] (Horowitz I Decl. ¶ 13; RT 41-42).

FN7. An IP address is a standard way of identifying a computer that is connected to the Internet. *United States v. Heckenkamp,* 482 F.3d 1142, 1144 (9th Cir.2007). With an IP address, a party could identify the Internet Service Provider ("ISP") providing internet service to the user of the computer corresponding to such IP address. *See In Re Charter Communications, Inc.,* 393 F.3d 771, 774 (8th Cir.2005). Only the ISP, however, could link the particular IP address to an individual subscriber.*Id.* As in the case of a subscriber to a particular telephone number, the identity of the subscriber to an IP address is not necessarily indicative of the person using the service at a given time.

FN8. As a general matter, logging data can be useful for maintenance and upkeep of a site, to identify and correct technical problems with the site, to examine the website traffic patterns and evaluate the performance of the site, and to audit and evaluate data related to advertising on the site. (Horowitz I Decl. ¶ 3).

B. Operation of Defendants' Website Prior to the Filing of Plaintiffs' Motion

***3** Defendants' web server is located in the Netherlands. (Jt. Bunnell/Parker Decl. ¶ 6). A factor in the decision to use a server in the Netherlands was to attract business from those individuals who did not wish their identities to be known, as defendants believe the Netherlands to have stricter privacy laws governing such information. (RT 122-23). Defendants use the web server Microsoft Internet Information Services (IIS) 6.0 to operate their website. (Horowitz I Decl. ¶ 9 Horowitz II Decl. ¶ 2; Jt. Bunnell/Parker Decl. ¶ 5). The IIS web server program contains logging functionality-meaning that it has the capacity, if the logging function is not disabled, to retain the Server Log Data. (Horowitz I Decl. ¶ 10; Horowitz II Decl. ¶ 2; Jt. Bunnell/Parker Decl. ¶ 5).[FN9]

FN9. It is the default when IIS is installed, for logging to be on. (RT 144; Horowitz I Decl. ¶ 10).

Since its inception, defendants' website's logging function has not been enabled to retain the Server Log Data. (RT 99; Parker I Decl. ¶ 3). Such logging is not necessary to, or part of defendants' business operations. (Parker I Decl. ¶ 3). The decision not to enable the logging function was based, at least in part, on the belief that the failure to log such information would make the site more attractive to users who did not want their identities known for whatever reason.[FN10](RT 122). Although defendants did not affirmatively retain the Server Log Data through logging or other means, the data went through and was temporarily stored in the RAM of defendants' website server for approximately six hours. (RT 47-48, 49-50, 54-55, 76; Jt. Bunnell/Parker Decl. ¶ 5).

FN10. Defendants' privacy policy, which is posted on defendants' website, advises users, *interalia,* that the site "will not collect any personal information about you [the user] except when you [the user] specifically and knowingly provide such information."(Parker I Decl., Ex. B). The policy further reflects that the site reserves the right at any time to modify, alter or update the policy, but that if the site does so, it will post the changes so that users are always aware of what information the site collects, how the information is used, and under what circumstances the information is disclosed. (Parker I Decl., Ex. B). Defendants have presented no evidence as to whether or how the term "personal information" is defined in the privacy policy. As an IP address identifies a computer, rather than a specific user of a computer, it is not clear that IP addresses, let alone the other components of the Server Log Data in issue, are encompassed by the term "personal information" in defendants' website's privacy policy. *Seesupra* note 7.

C. Operation of Defendants' Website Proximate or Subsequent to the Filing of Plaintiffs' Motion

At some point proximate or subsequent to the filing of Plaintiffs' Motion, defendants altered the method through which the website operates. (RT 54). Defendants' server no longer receives all, or all facets of the Server Log Data, or at least not in the same way.[FN11](RT 47, 56, 111). Instead, defendants now contract with a third party entity, "Panther," which essentially serves as a middleman in the process. (RT 98). Panther has multiple servers around the world, including approximately 25 servers in the United States. (RT 48, 55). Requests from users who visit defendants' website for a dot-torrent file on defendants' server are now routed from a location not hosted on defendants' server to a Panther server geographically proximate to the users making the requests. (RT 53, 56-57). Panther's servers in the United States serve United States users. (RT 124). In cases involving an initial request for a specific dot-torrent file, defendants' website now receives such request from Panther. (RT 57). Defendants' website sends the requested dot-torrent file to Panther. (RT 57). Panther then sends the file to the original requesting party. (RT 57). However, once a particular dot-torrent file has been requested from defendants' website by Panther, Panther then caches it and can provide it in response to subsequent requests for the same dot-torrent file without the need to obtain it from defendants' server. (RT 51-53, 57-58). In the latter circumstance, defendants' server no longer receives data reflecting a request to download the particular dot-torrent file. (RT 58). Thus, Panther now receives the Server Log Data in issue in its RAM. (RT 98). Panther, however, does not retain logs of such information.[FN12](RT 75). Defendant Parker testified that defendants switched to Panther because it allows for significantly faster processing and delivery of content. (RT 102-03). Defendants deny that the decision to contract with Panther was motivated by a desire to avoid being in possession of Server Log Data or to bypass a possible court order. (RT 50, 103, 123).[FN13]

FN11. Prior to the filing of Plaintiffs' Motion, defendants' website provided links to third-party sites that have torrent files on their sites, as well as links to torrent files on the cache of defendants' website. (RT 111). Once defendants made the recent change in their method of operation, defendants' website no longer does such caching. (RT 111). Instead, a third party under contract to defendants performs that function. (RT 111). However, when a user runs a search on defendants' website, every search is a request on defendants' server. (RT 126). Similarly, when a user gets a list of results back, clicks one of those links, and gets taken to a detailed dot-torrent page hosted by defendants' server, all of those pages-on which the names of dot-torrent files are identified-are hosted on defendants' server. (RT 127).

FN12. Defendant Parker testified that he was advised by a Panther representative that Panther does not have the capacity for full-server logging on all of its servers. (RT 75). Although plaintiffs argue that Panther can selectively log certain data, there is no evidence in the record as to whether Panther specifically has the capacity to log the Server Log Data in issue. (RT 177).

FN13. In light of the change in the method of operation, and the timing thereof, as well as the other evidence in the record, the court finds that defendants have the ability to manipulate at will how the Server Log Data is routed. Indeed, defendants represent that they could disengage and resume the functions currently performed by Panther if directed to log the Server Log Data in issue. (RT 72, 103-04).

D. Plaintiffs' Preservation Request

***4** On May 15, 2006, defendants sent a notice to plaintiffs' counsel formally reminding counsel and plaintiffs of their obligation to preserve all potentially discoverable evidence in their possession, custody or control related to the litigation, including all logs for the TorrentSpy website, and records of all communications between defendants and users of the website, including instant-messaging and other chat logs. (Pozza I Decl., Ex. H). This notice did not specifically request that defendants preserve Server Log Data temporarily stored only in RAM. Plaintiffs do not point to any other preservation request which specifically addresses data temporarily stored only in RAM. The court further notes that prior to the filing of Plaintiffs' Motion, the docket does not reflect that plaintiffs sought a preservation order.

IV. DISCUSSION

A. The Server Log Data in Issue Is Relevant

Pursuant to Rule 26(b)(1) of the Federal Rules of Civil Procedure, parties may obtain discovery regarding any matter, not privileged, that is relevant to the claim or defense of any party. F .R. Civ. P. 26(b)(1). Plaintiffs argue that the Server Log Data is relevant to numerous claims and defenses, including whether defendants' users have directly infringed plaintiffs' copyrighted works, and to what extent defendants' website is used for purposes of copyright infringement. (Plaintiffs' Motion at 1, 15-20). The court agrees. This case is predicated on theories of vicarious infringement, contributory infringement, and inducement. (Complaint ¶¶ 34-36). Primary infringement is a necessary predicate to such claims. *Perfect 10, Inc. v. Amazon.com, Inc.,* 487 F.3d 701, 2007 WL 1428632, *15 (9th Cir. May 16, 2007) (citing *A & M Records, Inc. v. Napster, Inc.,* 239 F.3d 1004, 1013 n. 2) (9th Cir.2001)). Defendants contest primary infringement. (Answer ¶ 33). Indeed, defendant Parker's testimony suggests his view that without logs, a case cannot be made against a website alleged to have engaged in secondary/contributory infringement because such logs are "essential" to finding direct infringers. (RT 129-30). There can be no serious dispute that the Server Log Data in issue is extremely relevant and may be key to the instant action.[FN14]

FN14. Defendants contend that plaintiffs' request for Server Log Data is overbroad because the vast majority of the website's users are located overseas such that their conduct cannot constitute copyright infringement. (RT 115-20, 125-26). The court rejects this contention. First, defendants' evidence regarding the volume of overseas traffic lacks foundation and is speculative at best. Second, even if defendants are correct regarding the asserted volume of overseas traffic, the court still finds such data to be relevant or reasonably calculated to lead to the discovery of relevant admissible evidence. Having said that, if (1) it is technically feasible; (2) defendants could reliably demonstrate that (i) Panther's United States servers process Server Log Data for users in the United States; and (ii) measures could be taken to protect against manipulation of the routing to alter the representative nature of such data; and (3) defendants choose to meet their obligations under this order by directing Panther to retain and provide defendants with the Server Log Data for dissemination to plaintiffs, the court would entertain a request to limit the required preservation and production to Server Log Data that is processed through the RAM of Panther's United States servers pursuant to its contract with defendants.

Alternatively, if a reliable and verifiable means exists to identify the country from which requests to defendants' website for dot-torrent files originated, the court would entertain a request to limit the required preservation and production to Server Log Data originating from users of defendants' website in the United States. The court does not view the data provided on the optional registration surveys referenced by defendant Parker during his testimony as a reliable and verifiable means to identify the country from which user requests originate. (RT 126).

B. The Server Log Data in Issue Is Electronically Stored Information

Rule 34(a) of the Federal Rules of Civil Procedure provides for the discovery of documents or electronically stored information-including writings, drawings, graphs, charts, photographs, sound recordings, images, and other data or data compilations stored in any medium from which information can be obtained. F.R. Civ. P. 34(a).“Rule 34(a) applies to information that is fixed in a tangible form and to information that is stored in a medium from which it can be retrieved and examined.”Advisory Comm. Notes to the 2006 Amendment of Rule 34. The Advisory Committee Notes further indicate that Rule 34(a)(1)“is expansive and includes any type of information that is stored electronically,” and that it “is intended to be broad enough to cover all current types of computer-based information, and flexible enough to encompass future changes and development.”*Id.*

***5** Defendants argue that the Server Log Data does not constitute electronically stored information under F.R. Civ. P. 34(a) because the data has never been electronically stored on their website or in any medium from which the data can be retrieved or examined, or fixed in any tangible form, such as a hard drive. (Defendants' Supp. Memo I at 1; Parker II Decl. ¶ 2). Plaintiffs assert that the Server Log Data is electronically stored information because such data is copied to the RAM while user requests are processed. (Plaintiffs' Supp. Memo II at 2; Horowitz II Decl. ¶ 4).

Although the parties point to no cases in which a court has assessed whether data present only in RAM constitutes electronically stored information under Rule 34, the Ninth Circuit has addressed whether data in RAM is electronically stored information in another context. In *MAI Systems Corp. v. Peak Computer, Inc.,* 991 F.2d 511, 518-19 (9th Cir.1993), the Ninth Circuit determined in the context of the Copyright Act, that software copied into RAM was “fixed” in a tangible medium and was sufficiently permanent or stable to permit it to be perceived, reproduced, or otherwise communicated for a period of more than transitory duration.[FN15]It defined RAM as “a computer component in which data and computer programs can be temporarily recorded.” *Id.* at 519 (citing *Apple Computer, Inc. v. Formula International, Inc.,* 594 F.Supp. 617, 622 (C.D.Cal.1984) (describing the copying of programs into RAM as a “temporary fixation”)). RAM has elsewhere been described as providing “temporary storage.” *See Adobe Systems Inc. v. Macromedia, Inc.,* 201 F.Supp.2d 309, 318 (D.Del.2002) (characterizing RAM as “temporary storage”); *seealso Apple Computer, Inc. v. Franklin Computer Corp.,* 714 F.2d 1240, 1243 n. 3 (3d Cir.1983) (“RAM ... is a chip on which volatile internal memory is stored which is erased when the computer's power is turned off.”).

FN15. The Ninth Circuit effectively reaffirmed the continuing viability of *MAI* in it recent opinion *Perfect 10, Inc. v. Amazon.com, Inc.,* 487 F.3d 701, 2007 WL 1428632 (9th Cir. May 16, 2007). In that case, the court stated: “A photographic image is a work that is “ ‘fixed” in a tangible medium of expression’ for purposes of the Copyright Act, when embodied (i.e., stored) in a computer's server (or hard disk, or other storage device). The image stored in the computer is the ‘copy’ of the work for purposes of copyright law. *See MAI Sys. Corp. v. Peak Computer, Inc.,* 991 F.2d 511, 517-18 (9th Cir.1993) (a computer makes a ‘copy’ of a software program when it transfers the program from a third party's computer (or other storage device) into its own memory, because the copy of the program recorded in the computer is ‘fixed’ in a manner that is ‘sufficiently permanent or stable to permit it to be perceived, reproduced, or otherwise communicated for a period of more than transitory duration.” ’ *Perfect 10, Inc.,* 487 F.3d 701, 2007 WL 1428632, at *6.

In light of the Ninth Circuit's decision in *MAI,* and the similarity between the definitions of electronically stored information in the Advisory Committee Notes to Rule 34 and the Copyright Act, the latter of which was in issue in *MAI,* this court concludes that data in RAM constitutes electronically stored information under Rule 34. Based on the evidence in the record, the court finds that the Server Log Data in this case is transmitted through and temporarily stored in RAM while the requests of defendants' website users for dot-torrent files are processed. Consequently, such data is electronically stored information under Rule 34.

C. The Server Log Data in Issue Is within the Possession, Custody or Control of Defendants

Rule 34(a) is limited in its scope to documents and electronically stored information which are in the possession, custody or control of the party upon whom the request is served. F.R. Civ. P. 34(a); *Rockwell Int'l Corp. v. H. Wolfe Iron & Metal Co.,* 576 F.Supp. 511, 512 (W.D.Pa.1983).

***6** Prior to the filing of Plaintiffs' Motion, the Server Log Data was received, at least in large part, in defendants' website's RAM, and therefore was clearly within defendants' possession, custody and control. As the Server Log Data is now directed to Panther's RAM as opposed to the RAM on defendants' website, the court must also consider whether the Server Log Data routed to Panther is in defendants' possession, custody or control.

Federal courts have consistently held that documents are deemed to be within a party's possession, custody or control for purposes of Rule 34 if the party has actual possession, custody or control, or has the legal right to obtain the documents on demand. *In re Bankers Trust Co.,* 61 F.3d 465, 469 (6th Cir.1995); *seealso United States v. International Union of Petroleum and*

Industrial, Workers, AFL-CIO, 870 F.2d 1450, 1452 (9th Cir.1989) ("Control is defined as the legal right to obtain documents upon demand."). The record reflects that defendants have the ability to manipulate at will how the Server Log Data is routed. Consequently, the court concludes that even though the Server Log Data is now routed to Panther and is temporarily stored in Panther's RAM, the data remains in defendants' possession, custody or control.

D. Requiring the Preservation and Production of the Server Log Data Is Not Tantamount to Requiring the Creation of New Data

Rule 34 only requires a party to produce documents that are already in existence. *Alexander v. FBI,* 194 F.R.D. 305, 310 (D.D.C.2000). Accordingly, "a party cannot be compelled to create, or cause to be created, new documents solely for their production." *Paramount Pictures Corp. v. Replay TV ("Replay TV"),* 2002 WL 32151632, *2 (C.D.Cal.2002) (citing *Alexander,* 194 F.R.D. at 310).

Defendants argue that because their website has never recorded or stored Server Log Data since the commencement of the website's operations, requiring defendants to retain such data would be tantamount to requiring them to create a record of the Server Log Data for its production. Plaintiffs contend that the Server Log Data already exists because such data is generated by the website users, received by a web server operated by, or under contract to defendants, and utilized to respond to user requests. As suggested by the court's analysis above, the court concludes that the Server Log Data in issue exists and, at least until recently, was temporarily stored in defendants' RAM.

As noted above, because the Server Log Data is temporarily stored in Panther's RAM, and is in the possession, custody or control of defendants, defendants would not be required to create new information for its production. This case is thus distinguishable from *Replay TV,* 2002 WL 32151632 (C.D.Cal.2002) and *Alexander,* 194 F.R.D. 305 (D.D.C.2000) on which defendants heavily rely. In both of those cases, the courts found that the information sought by plaintiffs was never in existence. *See Replay TV,* 2002 WL 32151632, *2 (C.D.Cal.2002) (denying production of customer data because such information "is not now and has never been in existence"); *Alexander v. FBI,* 194 F.R.D. 305, 310 (D.D.C.2000) (denying production of certain list of names because there was no evidence that list existed and that the responding party was in possession of such list). In the instant case, because the Server Log Data already exists, is temporarily stored in RAM, and is controlled by defendants, an order requiring defendants to preserve and produce such data is not tantamount to ordering the creation of new data.

E. An Order Requiring the Preservation of Server Log Data Is Appropriate

***7** Plaintiffs' Motion requests that the court issue an order requiring defendants to preserve the Server Log Data. Plaintiffs contend, *interalia,* that defendants are and have been obligated to preserve the Server Log Data, and that activating a logging function to preserve and store the server log data would impose no undue burden or cost on defendants. Defendants object to plaintiffs' request for a preservation order on the grounds that the Server Log Data is not subject to any preservation obligation and that requiring such preservation would be unduly burdensome.

In determining whether to issue a preservation order, courts undertake to balance at least three factors: (1) the level of concern the court has for the continuing existence and maintenance of the integrity of the evidence in the absence of an order directing preservation; (2) any irreparable harm likely to result to the party seeking the preservation of the evidence absent an order directing preservation; and (3) the capability of the party to maintain the evidence sought to be preserved, not only as to the evidence's original form, condition or contents, but also the physical, spatial and financial burdens created by ordering evidence preservation. *Capricorn Power Co. v. Siemens Westinghouse Power Corp.,* 220 F.R.D. 429, 432-33 (W.D.Pa.2004).

As defendants do not currently retain and affirmatively object to retention of the Server Log Data, and in light of the key relevance of such data in this action, the first two factors clearly weigh in favor of requiring preservation of the Server Log Data.

The third factor requires more analysis. The parties offer drastically different views regarding the degree to which defendants may be burdened if they are required to preserve the Server Log Data. As the "burden" issues relative to preservation significantly overlap with the "burden" issues relative to production, the court will address such issues together.

First, the court considers the potential burden attendant to employing a technical mechanism through which retention of the Server Log Data in RAM may be enabled. Plaintiffs contend that employing such a technical mechanism would be a trivial matter involving little more than a setting change on the web server program. (Horowitz I. Decl. ¶ 15). Defendants concede that the activation of a logging function to enable the retention of Server Log Data in RAM, in and of itself, would not be difficult. (Jt. Bunnell/Parker Decl. ¶ 7). Consequently, the court finds that it would not be an undue burden on defendants to employ a technical mechanism through which retention of Server Log Data in RAM is enabled.[FN16]

> FN16. The record also reflects that a programmatic method (which is distinct from enabling the logging function) could be employed to retain the Server Log Data from http headers while the data is in RAM. (RT 78, 81). Employing such a technique would require the writing of a script to collect the Server Log Data which would take several hours. (RT 78, 81). The court also find that the use of the programmatic method would not impose an undue burden on defendants.

Second, the court considers the potential burden attendant to actually retaining (*i.e.,* recording and storing) and producing the Server Log Data. Defendants contend that the burdens attendant to recording, storing and producing the Server Log Data would be technically, financially, and legally prohibitive. Plaintiffs disagree and argue that most of defendants' contentions are based on an incorrect premise and a vastly overbroad assumption regarding the scope and volume of data in issue.

(i) Volume of Data/Resulting Costs/Impact on Website Functionality

***8** Defendants represent that the Server Log Data would accumulate 30-40 gigabytes (30,000 to 40,000 megabytes) a day-a volume which defendants' current server does not have the capacity to record, store or copy, and the retention of which would negatively affect the functionality of their website, and require a costly re-design of their system and the installation of new equipment.[FN17](Jt. Bunnell/Parker Decl. ¶¶ 6, 8). Defendants further argue that the costs of producing such material would be prohibitive.[FN18]However, during the hearing in this matter, it became evident that defendants' representation regarding the volume of Server Log Data was significantly overstated. Rather than estimating the volume of incoming Server Log Data only, defendants estimated the volume of *all* requests for data.[FN19](RT 60-62). On cross-examination, defendant Parker conceded that collecting and recording only the subset of Server Log Data would "most likely" result in a volume of data far less than 40 gigabytes (40,000 megabytes) a day. (RT 82). Plaintiffs' expert in fact testified that the Server Log Data would likely have a volume of one-hundredth of what defendant Parker had originally suggested (*i.e.,* 300 to 400 megabytes).[FN20] (RT 134). Defendant Parker testified that he had not considered data storage issues if the volume was significantly smaller, *i.e.,* if the Server Log Data in issue had a volume of only one gigabyte (1000 megabytes) a day.[FN21](RT 82-83). He did concede, however, that if the logging was limited to only the Server Log Data (as opposed to *all* incoming data), he would not have the same concerns about, *interalia,* computer processing unit usage.[FN22](RT 86).

FN17. Based on the (incorrect) assumption that the data to be preserved would have a volume of 30 to 40 gigabytes a day, defendants estimate that they would either need to redevelop their existing server at an estimated cost of $10,000 and an expenditure of two weeks of time, or terminate their existing arrangement and set up a new higher capacity server sytem at an estimated cost of $50,000. (Defendants' Supp. Memo II at 5; Jt. Bunnell/Parker Decl. ¶¶ 6, 8).

FN18. Defendants contend that since they are not physically in the Netherlands where their server is located, saving the Server Log Data would require a File Transfer Protocol ("FTP") download of the files from the server. (Jt. Bunnell/Parker Decl. ¶ 6). Based again on the (incorrect) assumption that the volume in issue is 30 to 40 gigabytes a day, defendants represent that it would be impossible to download this volume in a single download day. (Jt. Bunnell/Parker Decl. ¶ 6). Defendants argue that even if this volume of data could be burned onto a DVD, approximately 10 DVDs would need to be burned on a daily basis, and then shipped overseas, requiring an unreasonable amount of human labor time spent processing and burning the data. (Defendants' Supp. Memo II at 3; Jt. Bunnell/Parker Decl. ¶ 6).

FN19. Defendant Parker testified that he based his estimate on the volume of logging "everything"-"every image, any kind of thing that loads up to the user"-because he did not believe that the logging function could be selectively enabled to retain just the Server Log Data. (RT 60-62). The court does not accept defendant Parker's testimony regarding the inability to selectively enable logs to retain solely the Server Log Data in issue. Indeed, defendant Parker ultimately conceded, after reviewing an exhibit offered by plaintiffs, that the software used by defendants' website could create server logs for limited amounts of data and could save it in a particular folder. (RT 78). The court concludes that defendant Parker either did not know that the logs could be selectively enabled to collect the Server Log Data only or that he intentionally misrepresented the volume of data in issue. The former suggests a lack of knowledge and expertise which significantly undercuts his testimony. The latter suggests a lack of candor which likewise significantly undercuts his testimony. As the incorrect assumption that logs could not be selectively enabled serves as the predicate for virtually all of defendants' testimony and declarations regarding the alleged burden that would be imposed upon defendants if they were required to preserve and produce just the Server Log Data, such testimony and declarations are completely undercut and not viewed by this court as credible.

FN20. Plaintiffs contend that even if the data generated a few gigabytes of storage space per day, the data could be backed up on a DVD, which can store up to four gigabytes of data and would take around five to ten minutes. (Horowitz Decl. ¶ 18). Plaintiffs further assert that storing the data would not be costly because a DVD can be purchased for under a dollar. (Horowitz Decl. ¶ 18).

FN21. Defendant Parker also failed to consider that the volume of even just the Server Log Data would be further significantly reduced if compressed, or if collected in binary (rather than text) format. (RT 83-84, 135-36).

FN22. Defendant Parker similarly indicated that he would not have the same concerns if the programmatic method was limited to retention of only the Server Log Data (as opposed to all incoming data). (RT 86).

Based upon the evidence regarding the estimated volume of data resulting from the logging of solely the Server Log Data in issue (as opposed to all data) and the other evidence presented, the court finds that defendants would not be unduly burdened as a consequence of the volume of Server Log Data if required to preserve and produce such data.

(ii) Privacy/First Amendment/Federal Statutory Issues

Defendants also raise issues concerning the privacy of their website users based upon defendants' privacy policy, the First Amendment and multiple federal statutes. (Defendants' Supp. Memo II at 8-15). Although the court discusses each such issue below, the court does not find defendants' arguments to be persuasive, particularly in light of the fact that this order directs defendants to mask users' IP addresses before the Server Log Data is produced.[FN23] The court finds that defendants' asserted interest in maintaining the privacy of the users of their website can be adequately protected by the protective order already entered in this action and the masking of the users' IP addresses. *See Farber,* 234 F.R.D. at 191.

FN23. Although defendants suggest that the actual IP addresses could be retrieved from masked/encrypted IP addresses through "brute force," the court has protected against that by prohibiting plaintiffs from taking any measures to unmask or decrypt the masked/encrypted IP addresses.

(a) Privacy Policy

Defendants contend that Plaintiffs' Motion should be denied because plaintiffs' privacy policy precludes them from preserving and producing "personal information" about their website's users. The court rejects this contention.

***9** First, defendants cannot insulate themselves from complying with their legal obligations to preserve and produce relevant information within their possession, custody or control and responsive to proper discovery requests, by reliance on a privacy policy-the terms of which are entirely within defendants' control.

Second, even if a litigant's privacy policy could have such an impact, it is not clear to the court that defendants' current privacy policy actually prohibits the retention and production of the Server Log Data. *Seesupra* note 10. Moreover, the record reflects that despite this policy, defendants, unbeknownst to their users, do disclose IP addresses and search queries to third parties, albeit without disclosure of clicks on dot-torrent download links. (RT 90-97).

Third, to the extent defendants' privacy policy may prohibit the disclosure of IP addresses, compliance with this order does not violate such policy because IP addresses are to be masked.

Finally, even if the privacy policy currently prohibits the retention and disclosure of the Server Log Data, the policy itself advises users that such policy may be modified at any time. As this order does not contemplate the historical retention and production of data from users who have arguably relied on the existing policy, and as nothing in this order prevents defendants from modifying their privacy policy so that it accurately reflects defendants' prospective retention and production obligations pursuant to this order, defendants themselves retain the ability to ensure that they do not violate their own privacy policy.

(b) First Amendment

Defendants also argue that Plaintiffs' Motion should be denied because the First Amendment protects anonymous speech on the internet.

The First Amendment protects anonymous speech, at least in circumstances involving core First Amendment expression such as political speech. *See McIntyre v. Ohio Elections Commission,* 514 U.S. 334, 115 S.Ct. 1511, 131 L.Ed.2d 426 (1995) (discussing central role of anonymous speech in free marketplace of ideas). At least one court, in the context of a third party subpoena, has also concluded that the anonymous use of file sharing/copying networks to download and disseminate copyrighted material without permission qualifies for minimal First Amendment protection subject to other considerations. *In re Verizon Internet Services, Inc.,* 257 F.Supp.2d 244, 260 (D.D.C.), *rev'd on other grounds,* 351 F.3d 1229 (D.D.C.2003).

This court assumes, without deciding that the users of defendants' website are entitled to limited First Amendment protection. However, even assuming such protection applies, the court finds that the preservation and disclosure of the Server Log Data does not encroach or substantially encroach upon such protection, particularly in light of the fact that such data does not identify the users of defendants' website and that the IP addresses of such users have been ordered to be masked.

(c) Stored Communications Act

***10** Defendants argue that Plaintiffs' Motion should be denied because the Stored Communications Act (18 U.S.C. §§ 2701-11) prohibits the disclosure of the Server Log Data. Title 18, United States Code, Section 2702, generally prohibits a person or entity providing an electronic communication service to the public from knowingly divulging the contents of a communication while in electronic storage. 18 U.S.C. § 2702(a). Specifically excepted from this prohibition are disclosures of the contents of communications (1) to an intended recipient of such communication or an agent thereof; or (2) with the lawful consent of an intended recipient of such communication.[FN24]18 U.S.C. §§ 2702(b)(1), 2702(b)(3).

FN24. As the cases upon which defendants rely involve third party subpoenas to electronic server providers who were not the intended recipients of the communications in issue, they are not applicable.

As defendants' website is the intended recipient of the Server Log Data, and defendants have the ability to consent to the disclosure thereof, this statutory provision does not provide a basis to withhold such data which is clearly within defendants' possession, custody and control.[FN25]

FN25. As the good faith reliance on a court order (such as the instant order) provides a complete defense to any civil or criminal action predicated on a violation of the above-referenced non-disclosure provision, the court also rejects defendants' assertions of burden based on the potential of being sued for violating this provision. 18 U.S.C. § 2707(e).

(d) The Wiretap Act

Defendants argue that Plaintiffs' Motion should be denied because the Wiretap Act (18 U.S.C. §§ 2510-22) prohibits the disclosure of the Server Log Data.

Title 18, United States Code, Section 2511, generally prohibits the intentional interception of electronic communications during the transmission thereof and the disclosure of such intercepted communications. 18 U.S.C. §§ 2511(a), 2511(c), 2510(12).Title 18, United States Code, Section 2510(12) defines "electronic communication" as "any transfer of signs, signals, writing, images, sounds, data, or intelligence of any nature transmitted in whole or in part by a wire, radio, electromagnetic, photoelectronic or photoptical system that affects interstate or foreign commerce" except as expressly excluded therein. Specifically excepted from the prohibition against the interception and disclosure of electronic communications are: (1) the interception by a party to the communication; (2) the disclosure of the contents of such communication while in transmission to the intended recipient of such communication or an agent thereof; and (3) the disclosure of the contents of such communication while in transmission with the lawful consent of an intended recipient of such communication. 18 U.S.C. §§ 2511(2)(d), 2511(3)(a), 2511(3)(b)(ii).

First, the court concludes that this statute is not implicated because, as to electronic communications, it only prohibits interceptions during transmission (not while in electronic storage, *i.e.,* RAM), and the disclosure of electronic communications intercepted during transmission. *See Konop v. Hawaiian Airlines, Inc.,* 302 F.3d 868, 878-79 (9th Cir.2002). This is true even though storage is a necessary incident to transmission. *Id.* at 879 n. 6.

Second, even if the Server Log Data were considered to be in transmission while in RAM, and therefore subject to this statute's prohibition against interception and disclosure, the statute would still not relieve defendants of their obligation to preserve and produce such data. As defendants' website is the intended recipient of the Server Log Data, and defendants can lawfully intercept and consent to the disclosure thereof, this statutory provision, even if applicable would not provide a basis to withhold such data which is clearly within defendants' possession, custody and control.[FN26]

FN26. As the good faith reliance on a court order (such as the instant order) provides a complete defense to any civil or criminal action predicated on a violation of the above-referenced non-disclosure provision, the court also rejects defendants' assertions of burden based on the potential of being sued for violating this provision. 18 U.S.C. § 2520(d)(1).

(e) The Pen Register Statute

***11** Defendants also argue that Plaintiffs' Motion should be denied based on the Pen Register Statute (18 U.S.C. §§ 3121-27).

Title 18, United States Code, Section 3121, generally prohibits the installation and use of pen registers and trap and trace devices except in the circumstances referenced therein. 18 U.S.C. § 3121(a). A pen register is essentially a device which captures outgoing telephone numbers or IP addresses.[FN27] A trap and trace device essentially captures incoming IP addresses or telephone numbers (such as a caller identification device).[FN28] Excepted from this prohibition are pen register and trap and trace devices used by providers of electronic communication services relating to the operation and maintenance of such service. 18 U.S.C. § 3121(b)(1).

FN27. More specifically, a pen register is a device or process which records dialing, routing, addressing or signaling information transmitted by an instrument or facility from which a wire or electronic communication is transmitted, excluding the contents of any communication. 18 U.S.C. § 3127(3). Such term does not include (i) any device or process used by a provider of electronic communication service for billing, recording as an incident to billing, or providing communications services; or (ii) any device or process used by such provider for cost accounting or other like purposes in the ordinary course of its business. 18 U.S.C. § 3127(3).

FN28. More specifically, a "trap and trace device" is a device or process which captures the incoming electronic or other impulses which identify the originating number of an electronic communication, excluding the contents of any communication. 18 U.S.C. § 3127(4).

As the Server Log Data sought by plaintiffs encompasses incoming IP addresses, it arguably implicates the prohibition against the unauthorized use of trap and trace devices. However, as plaintiffs correctly note, the collection of incoming IP addresses by defendants is exempt from this prohibition pursuant to 18 U.S.C. § 3121(b)(1) because defendants already and necessarily capture such data in their RAM (or Panther's RAM) to operate the website.

(f) Impact on Good Will

Defendants also argue that they would lose business and good will of customers and advertisers as result of the stigma that would flow from any order directing them to preserve and produce the Server Log Data. (Jt. Bunnell/Parker Decl. ¶ 9; RT 152-55).

The testimony and declarations of defendants Parker and Bunnell regarding such loss of good will and business is largely speculative, conclusory and without foundation.[FN29]Nonetheless, in light of the discussion in *Gonzales v. Google, Inc.,* 234 F.R.D. 674, 684 (N.D.Cal.2006), the court recognizes that the preservation and production of the Server Log Data may negatively impact the way in which defendants' website is perceived by its users and advertisers and result in a loss of business and good will. Notably, these concerns did not prevent the court in *Gonzales* from ordering a third party to disclose certain data to the United States government.

FN29. For example, although defendant Bunnell testified that the sites Grokster and Lokitorrent "were basically shut down" because they were "forced to turn over log information" (RT 153), on cross-examination, it became clear that he did not have any personal knowledge regarding such matters and that his testimony was, at most, based on things he had read or heard which might or might not be true. (RT 159-62). Similarly, defendant Bunnell provided a declaration and testified regarding his concern about suffering the same type of consequences as AOL, which defendants contend was sued because it published search queries and log-in information excluding IP addresses on the internet. (RT 153-54). However, it again became clear during cross-examination that defendant Bunnell's testimony was speculative and without foundation. Indeed, although a copy of a complaint against AOL was attached to and referenced in his declaration, Bunnell apparently did not even realize that the testimony he was providing about such lawsuit related to said complaint as he both denied having read it and then affirmed having read it. (RT 163-65). The court observes, based on its review of the copy of the complaint against AOL that is of record, that the data in issue in that case, unlike the Server Log Data in issue here, encompassed personal identifying user names, street addresses, dates of birth, phone numbers, credit card numbers, and social security numbers. (Jt. Bunnell/Parker Decl., Ex. C). The AOL case also does not appear to have involved disclosure pursuant to a court order as contemplated in the instant case. (Jt. Bunnell/Parker Decl., Ex. C).

In this case involving the preservation and disclosure by a party to another private civil litigant, the court finds that preservation and production of the Server Log Data is appropriate in light of the conclusory and speculative nature of the evidence presented regarding the loss of good will and business, the key relevance and unique nature of the Server Log Data in this action, the lack of a reasonable alternative means to obtain such data, and the limitation imposed by the court regarding the masking of IP addresses.[FN30]

FN30. Defendants suggest that Digital Millennium Copyright Act ("DMCA") subpoenas are available to plaintiffs pursuant to 17 U.S.C. § 512(h), and provide a more convenient, less burdensome, and less expensive means of obtaining the Server Log Data. The court rejects defendants' assertion. The DMCA permits, under circumstances specified therein, subpoenas to be issued for "information sufficient to identify [an] alleged infringer."17 U.S.C. § 512(h)(1). Defendants have not satisfied the court that the Server Log Data (and all facets thereof) may permissibly be sought pursuant to such subpoenas, or that DMCA subpoenas are a viable alternative in this action. In any event, the court does not find that DMCA subpoenas would be "more convenient, less burdensome, or less expensive."

In light of fact that the Server Log Data is currently routed to Panther, the court has also considered whether a third party discovery request to Panther would be a viable alternative. The court concludes that while such data may well be obtainable from Panther, requiring plaintiffs to pursue that avenue would likely not be "more convenient, less burdensome, or less expensive" in light of the nature of the relationship between defendants and Panther, the nature of the information sought, and the other evidence presented in this matter.

(iii) International Issues

Defendants further assert that any changes to the existing web server would need to be in compliance with Netherlands law because defendants lease their server from an Internet Service Provider in Amsterdam, Netherlands and their server is located at the ISP's secure plant. (Defendants' Supp Memo II at 2; Jt. Bunnell/Parker Decl. ¶ 6). Defendants have offered evidence that defendants' contract with the entity from which it leases its Netherlands server is governed by Netherlands law. (Jt. Bunnell/Parker Decl., Ex. A). Defendants have also supplied the court with the Netherlands Personal Data Protection Act which is directed to "information relating to an identified or identifiable person."(Jt. Bunnell/Parker Decl., Ex B). The court is not persuaded that such concerns should relieve defendants of their obligation to preserve and produce the Server Log Data.

***12** First, as it now appears that the entity which has immediate possession of the Server Log Data has over 25 United States servers, defendants' expressed international concerns no longer appear valid. At a minimum, their expressed concerns carry less weight in light of their use of Panther's services and the fact that defendants retain the ability to manipulate the routing of the Server Log Data.

Second, even if such concerns remain, it is not clear that the Netherlands' Personal Data Protection Act applies to IP addresses, let alone to the other Server Log Data in issue, as an IP address identifies a computer, rather than a specific user of a computer. *Seesupra* note 7. A party relying on foreign law has the burden of showing that such law bars the discovery in issue. *United States v. Vetco,* 691 F.2d 1281, 1289 (9th Cir.1981). Defendants have not met this burden.

Third, even if the Netherlands' statute applies and is read to prohibit defendants' preservation or production of the Server Log Data, it is well settled that foreign blocking statutes do not deprive an American court of the power to order a party subject to its jurisdiction to produce (let alone preserve) evidence even though the act of production may violate that statute. *Richmark Corp. v. Timber Falling Consultants,* 959 F.2d 1468, 1474 (9th Cir.1992) (citation and internal quotations omitted). In considering whether to excuse noncompliance with discovery orders based on foreign statutory bars, as opposed to issuance of an order directing the preservation or production of evidence which is the issue here, courts are to balance the relevant factors in issue. *Id.* at 1474-75.These factors include the importance of the information requested in the litigation, the degree of specificity of the request, whether the information originated in the United States, the availability of alternative means of securing the information, the extent to which noncompliance would undermine important interests of the United States or compliance would undermine important interests of the state where the information is located, and the degree of hardship on the producing party and whether such hardship is self-imposed. *Richmark Corp.,* 959 F.2d at 1475-77).

The court has weighed such factors in assessing whether to direct defendants to preserve and produce the Server Log Data-to the extent evidence bearing upon such factors has been presented. The court concludes that these factors weigh in favor of requiring defendants to preserve and produce the Server Log Data. The court primarily relies upon the key relevance of the Server Log Data to this action, the specificity of the data sought, the lack of alternative means to acquire such information, and the fact that defendants are United States individuals and entities who affirmatively chose to locate their server in the Netherlands at least in part to take advantage of the perceived protections afforded by that country's information security law.

***13** In sum, defendants have failed to demonstrate that their expressed international concerns should relieve them of the obligation to preserve and produce the Server Log Data.

F. An Order Requiring the Production of Certain Server Log Data Is Appropriate

Defendants contend that they should not be ordered to produce the Server Log Data for the same reasons, discussed above, that cause defendants to believe that a preservation order should not issue. Plaintiffs maintain that such data should be produced, at least in a form that masks the IP addresses.

On a motion to compel discovery, the party from whom electronically stored information is sought must show that the information is not reasonably accessible because of undue burden or cost. F.R. Civ. P. 26(b)(2)(B). If such a showing is made, a court may nonetheless order discovery from such sources if the requesting party shows good cause, considering the limitations of F.R. Civ. P. (b)(2)(C). A court may limit discovery of electronic materials under F.R. Civ. P. 26(b)(2)(C) if: (i) the discovery sought is unreasonably cumulative or duplicative, or is obtainable from some other source that is more convenient, less burdensome, or less expensive; (ii) the party seeking discovery has had ample opportunity by discovery in the action to obtain the information sought; or (iii) the burden or expense of the proposed discovery outweighs its likely benefit, taking into account the needs of the case, the amount in controversy, the parties' resources, the importance of the issues at stake in the litigation, and the importance of the proposed discovery in resolving the issues. F.R. Civ. P. 26(b)(2)(C).

Based on the discussion, analysis, and findings above, the court further finds: (1) defendants have failed to demonstrate that the Server Log Data is not reasonably accessible because of undue burden or cost; (2) plaintiffs have shown good cause to order discovery of such data; (3) the discovery sought is not unreasonably cumulative or duplicative or obtainable from some other source that is more convenient, less burdensome, or less expensive; (4) plaintiffs have not otherwise had the opportunity to obtain the data sought; and (5) the burden and expense of the proposed discovery does not outweigh its likely benefit, taking into account the needs of the case, the amount in controversy, the parties' resources, the importance of the issues at stake in the litigation, and the importance of the proposed discovery in resolving the issues.[FN31]

> FN31. The court emphasizes that its ruling should *not* be read to require litigants in all cases to preserve and produce electronically stored information that is temporarily stored only in RAM. The court's decision in this case to require the retention and production of data which otherwise would be temporarily stored only in RAM, is based in significant part on the nature of this case, the key and potentially dispositive nature of the Server Log Data which would otherwise be unavailable, and defendants' failure to provide what this court views as credible evidence of undue burden and cost.

G. Evidentiary Sanctions

Plaintiffs' Motion also requests evidentiary sanctions against defendants in light of defendants' alleged wilful failure to preserve, and intentional spoliation of, the Server Log Data. (Plaintiffs' Motion at 13-14).

Pursuant to F.R. Civ. P. 37(f), absent exceptional circumstances, a court may not impose sanctions under the discovery rules based on a party's failure to provide electronically stored information lost as a result of the routine, good faith operation of an electronic information system. F.R. Civ. P. 37(a). A "good faith" operation may require a party to modify or suspend certain features of that routine operation to prevent the loss of information, if that information is subject to a preservation obligation. Advisory Comm. Notes to the 2006 Amendment to Rule 37.

***14** A litigant is under a duty to preserve what it knows, or reasonably should know, is relevant in the action, is reasonably calculated to lead to the discovery of admissible evidence, is reasonably likely to be requested during discovery, and/or the subject of a pending discovery request. *Wm. T. Thompson Co. v. General Nutrition Corp.,* 593 F.Supp. 1443, 1455 (C.D.Cal.1984). Therefore, "[o]nce a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents." *Zubulake v. USB Warburg LLC,* 220 F.R.D. 212, 218 (S.D.N.Y.2003). As a general rule, the litigation hold does not apply to inaccessible electronically stored information, such as back-tapes, which may continue to be recycled on the schedule set forth in the company's policy. *See id.*

As noted above, although this court now finds that defendants have an obligation to preserve the Server Log Data in issue that is temporarily stored only in RAM, in the absence of (1) prior precedent directly on point in the discovery context; (2) a specific request by defendants to preserve Server Log Data present solely in RAM; and (3) a violation of a preservation order, this court finds that defendants' failure to retain the Server Log Data in RAM was based on a good faith belief that preservation of data temporarily stored only in RAM was not legally required. Consequently, the court finds that evidentiary sanctions against defendants for spoliation of evidence are not appropriate.

H. Attorneys' Fees and Costs

Defendants request that the court require plaintiffs to pay reasonable expenses incurred in opposing Plaintiffs' Motion, including attorneys' fees, pursuant to F.R. Civ. P. 37(a)(4)(B). As Plaintiffs' Motion has largely been granted, the court finds that the award of such fees is not appropriate. To the extent Plaintiffs' Motion has been denied in part, the court finds that the making of such motion was substantially justified and that the award of expenses would be unjust.

V. CONCLUSION

Based upon the foregoing, IT IS HEREBY ORDERED:

1. Defendants are directed to commence preservation of the Server Log Data in issue within seven (7) days of this order and to preserve the Server Log Data for the duration of this litigation or until further of this court or the assigned District Judge. As the record reflects that there are multiple methods by which defendants can preserve such data, the court does not by this order mandate the particular method by which defendants are to preserve the Server Log Data.

2. Defendants shall initially produce the Server Log Data (with the exception noted below) by no later than two weeks from the date of this order. Defendants thereafter have a continuing obligation regularly (no less frequently than every two weeks) to update such production.[FN32]Although defendants are required to preserve the IP addresses of the computers used to request dot-torrent files, defendant are not, at least at this juncture, ordered to produce such IP addresses in an unmasked/unencrypted form. Instead, defendants shall mask, encrypt, or redact IP addresses through a hashing program or other means, provided, however, that if a given IP address appears more than once, such IP address is concealed in a manner which permits one to discern that the same IP address appears on multiple occasions.[FN33]Plaintiffs are prohibited from using “brute force” or any other means to pierce or reverse any such mask/encryption/redaction. The court does not by this order either mandate or prohibit notification to the users of defendants' website of the fact that the Server Log Data is being preserved and has been ordered produced with masked/encrypted/redacted IP addresses.[FN34]

FN32. Plaintiffs have represented that they are willing to accept a sample of Server Log Data of one hour a day, provided that the hour each day is selected to provide a representative picture of the usage of defendants' site. (RT 180-81). The court has not limited its order to sampling at this juncture because of concerns that one hour a day will not provide a representative sample of activity in light of defendants' expressed concerns regarding its notification and disclosure obligations vis-a-vis its users. However, the court encourages the parties to meet and confer regarding sampling, and, if appropriate, to prepare a stipulation accordingly modifying the scope of preservation and production required by this order. In the absence of such a stipulation, the instant order is without prejudice to a request by defendants to share or shift the costs of preservation and production.

FN33. For example, if, hypothetically, an IP address of “1234.5678.9101” which requested a dot-torrent file on day one at noon, was masked as “abcd.efgh.ijkl,” and the same IP address requested a dot-torrent file on day two at noon, defendants' production should reflect that “abcd.efgh.ijkl” made the request on day two at noon as well as on day one at noon.

FN34. Having said that, absent further order of this court or the assigned District Judge, the Clerk is directed to file and maintain this order *underseal* for a period of seven (7) days. The court finds good cause to file such order *underseal* for at least the limited seven-day period in light of the nature of its contents and the fact that it may be based, at least in part on materials submitted *underseal* pursuant to a protective order. The parties shall have five (5) days from the date of this order to submit any objections to the public filing of this order or any portion thereof. Any such objections should state the legal reason therefor and be accompanied by a proposed redacted version of the order which, in the objecting parties' view, is appropriate for public filing. If no objections are timely received, and absent further order of this court or the assigned District Judge, the court will direct the Clerk to file this order in the public record at the expiration of the seven-day period.

***15** 3. Plaintiffs' request for evidentiary sanctions based upon plaintiffs' failure to date to preserve the Server Log Data is denied.

4. Defendants' request for attorneys' fees and costs pursuant to F.R. Civ. P. 37(a)(4)(B) is denied.

IT IS SO ORDERED.